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# Avoiding Federal Wealth Transfer Taxes

by

**Richard Schmalbeck**
Duke University School of Law

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ABSTRACT

It is widely assumed that federal wealth transfer taxes can be easily avoided. Although the amount of such taxes paid each year–frequently by very large and presumably well-advised estates–belies this assumption, there is nevertheless some truth in the idea that avoidance devices exist and are to a considerable degree effective in reducing the size of transfer tax liabilities. This paper will explore the major avoidance options currently in use, with short explanations of how each major category of avoidance measures operates, and the costs associated with the various strategies described. Included will be consideration of marital deduction trusts, insurance trusts, grantor retained annuity trusts (and close relatives), and family partnerships, among others. The selection of devices to be highlighted in this paper has been informed by conversations with a number of estate planners in five cities of varying sizes and types, who advise individuals and families with personal wealth ranging from roughly five million to several billion dollars.

Although many tax avoidance options in the income tax area involve acceptance of lower rates of return in exchange for favorable tax treatment (municipal bonds being the classic example), the primary tax avoidance costs in the transfer tax area appear to consist mostly of more inchoate costs: the cost of surrendering options to redirect the flow of largess at later dates, and the like. The direct and more tangible costs of transfer tax avoidance consist of the legal and trust management fees paid; while those fees are sizable in absolute terms, they are often negligible as a percentage of the wealth transfer itself.

# AVOIDING FEDERAL WEALTH TRANSFER TAXES

By Richard Schmalbeck

Duke University School of Law

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## A. Introduction

The current debate about the future of federal wealth transfer taxes is influenced by two widely held assumptions. The first is that these taxes can be easily avoided. The second is that the public and private costs associated with the transfer tax system are unacceptably large, in view of the modest contribution that wealth transfer taxes make to federal revenues.

The first assumption is to some degree belied by the sizable annual revenue generated by the transfer taxes, much of which is paid by the estates of very wealthy and presumably well-advised decedents. Although it is undeniable that avoidance devices exist and are to a considerable degree effective in reducing the size of a taxable estate, the efficacy of these devices has frequently been exaggerated in both popular and professional accounts of the avoidance possibilities.

The second assumption is somewhat at odds with the first: if avoidance strategies were easy, then private avoidance costs would be minimal. And if those strategies were certain and comprehensively effective, then public enforcement efforts would be unproductive, and hence unnecessary. In truth, whether the public and private costs of the transfer tax system are unacceptably large is not a question that is subject to definitive resolution, both because the costs are difficult to assess with any precision, and because there can be no consensus on what constitutes acceptable costs. However, this paper will argue that, just as the ease of avoidance has been exaggerated, so too have the costs, and that there is little reason to believe that the transfer tax system is significantly less efficient, in terms of the relationship between its costs and its revenues, than other taxes.

The remainder of this introductory Section A provides a summary of the current federal wealth transfer tax rules. Section B, the main body of the paper, explores the major avoidance options currently in use, with short explanations of how each major category of such measures operates, concluding with an assessment of the effectiveness of such strategies overall. The selection of devices to be highlighted in this section is meant to be representative of the strategies in most common contemporary use, and has been informed by interviews with a number of estate planners currently practicing in New York, Washington, Charlotte, Raleigh, and Winston-Salem, as well as officials of the Treasury Department and the Internal Revenue Service, to all of whom the author is deeply indebted.[1] Section C analyzes the costs of tax avoidance from several different perspectives. Section D summarizes the paper's findings, and offers some suggestions for reform of federal wealth transfer taxes.

The following brief sketch of the federal wealth transfer tax system will serve as background for the subsequent discussion of the avoidance devices.

1. The Federal Estate Tax -- The centerpiece of the transfer tax system is of course the federal estate tax, which has in various forms applied to decedents' estates since 1916. In its current form, it imposes a transfer tax on the passage of assets from an estate to the decedent's heirs and

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[1] I am grateful to the several estate planners who were kind enough to grant interviews during the preparation of this draft, all of whom preferred to remain anonymous. I am also indebted to Charles Clotfelter, Bill Gale, Deborah Geier, Joel Slemrod, Jay Soled, Larry Zelenak, and the participants in the Brookings conference on the future of the transfer tax system (May 4-5, 2000) for their very helpful comments on earlier drafts of this paper. Of course, any opinions expressed herein are my own, as are any errors.

beneficiaries in cases where the value of the taxable estate so transferred exceeds $675,000. The $675,000 exemption–which is technically achieved through the use of a "unified credit" equal to the tax on a taxable estate of precisely that size–is scheduled under current law to increase in unequal increments over the next several years, until it reaches $1,000,000, effective for estates of decedents dying in 2006 or later years.[2] Although the statutory rate structure runs from 18% to 55%, the actual marginal rate faced by estates subject to the tax begins at 37% for estates just over the $675,000 exemption level, reaches its highest marginal rate of 60% on estates between $10,000,000 and $17,184,000, and reverts thereafter to the statutory maximum rate of 55%.[3]

Congress has tried to give the estate tax a fairly broad reach, so that assets may be included in an estate even if the decedent enjoys less than full ownership of those assets at the time of death. For example, if a testator[4] gives away a remainder interest in property, but retains a life estate, the

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[2] The Taxpayer Relief Act of 1997, which will phase in a higher unified credit over the coming years, also changed the estate planning jargon. Although the caption of IRC sec. 2010 still refers to the "unified credit," the actual words of the code now describe the concept as "the applicable credit amount," and this latter term has come into common parlance among estate planners. However, because "applicable credit amount" is descriptively empty, this paper will continue to use the term "unified credit" (which does at least convey the linkage between the gift and estate taxes) to refer to the IRC sec. 2010 credit.

[3] IRC sec. 2001(c)(1). The rates below 37% are irrelevant because they are fully offset by the unified credit. Actual tax liabilities begin at the point that the credit is exhausted, and the rate schedule by that point is at 37%. The 60% bracket is intended to phase out the benefit of the rate brackets below the 55% bracket. Until 1997, the 60% bracket was also intended to phase out the benefits of the unified credit, but a technical defect in the Taxpayer Relief Act of 1997 omitted that effect. If this is corrected by a subsequent technical corrections bill, the 60% rate would fall back to the 55% rate on an estate of $24,100,000 by the time the $1,000,000 exemption is effective in 2006.

[4] A testator is simply a person who makes a legally valid will. Readers unfamiliar with some of the other terms in this paragraph, such as life estate or remainder interest, may wish to skip ahead to section A.3., in which some rudimentary trust concepts and terminology are explained.

value of the entire property will generally be included in the testator's estate.[5] Similar rules apply to property over which a testator has retained a power of appointment;[6] life insurance owned by the decedent (which ordinarily does not pass through the decedent's probate estate, but is rather paid directly to the beneficiaries);[7] annuities;[8] certain transfers within three years of death;[9] and so on.

On the other hand, the reach of the tax is circumscribed by a number of deductions, of which two are particularly important: there is an unlimited marital deduction, so that any part of the estate left to a surviving spouse may be deducted in full;[10] and there is an unlimited charitable deduction, allowing deduction in full of any testamentary gifts to charitable organizations or governmental units.[11] The impact of these deductions can hardly be overstated. For estates filing returns in 1997

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[5] IRC sec. 2036. There is, however, a credit for any gift tax paid on the original transfer of the remainder interest during the testator's life.

[6] IRC sec. 2041.

[7] IRC sec. 2042.

[8] IRC sec. 2039. Only annuities having a death benefit or refund feature, or those covering multiple lives, are includable under these provisions. A single-life annuity does not ordinarily pass anything to anyone at the death of the annuitant, and would not be included in a decedent's estate.

[9] IRC sec. 2035.

[10] IRC sec. 2056. The marital deduction, like a number of other rules in the estate and gift tax area, only applies in this way if the donee is a U.S. citizen. To avoid undue complications, it will be assumed throughout this paper that all transactions described are between U.S. citizens. Those who are interested in the treatment of gifts to non-U.S. spouses can look forward to the eventual publication of a work-in-progress by the author of this paper, who, for nontax reasons, married a Canadian citizen. The forthcoming article is titled: "I Married an Alien," (with an eye toward sale of the movie rights), and explains in horrific detail the unfortunate tax treatment of couples of mixed citizenship.

[11] IRC sec. 2055. This section covers more or less the same ground as IRC sec. 170, which provides the rules for income tax deductibility of charitable gifts.

the aggregate total of reported gross estates was over $162 billion.[12] The $73 billion difference between that number and the aggregate total of taxable estates reported in the same year (about $89 billion) is largely explained by the marital deductions claimed of $49 billion, and the charitable deductions of $14 billion.[13] Thus, it may be said that the federal estate tax is intended to apply to a broad sense of the decedent's wealth transferred at or because of death, but only to the extent that that wealth is transferred to someone other than a surviving spouse or a charitable entity.[14]

2. The Federal Gift Tax – If the tax rules are intended to impose significant tax burdens on transfers of wealth at death, attention must be given to the possibility that wealth transfers can–and in the absence of comparable burdens, probably will–take place in advance of death. The salience of this point was apparently not obvious to the Congress that first enacted the federal estate tax, for that tax had no counterpart gift tax. However, the avoidance opportunity had become clear enough

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[12] B. Johnson and J. Mikow, "Federal Estate Tax Returns, 1995-1997," 19 Statistics of Income Bull. 69, 104 (Table 1c., col. 2.) (Summer, 1999). These were the most recent estate tax return data available at the time this paper went to press.

[13] Id. At 106 (Table 1c., col. 60 (marital deduction) and 62 (charitable deduction).) The balance of the deductions are composed largely of the deduction for estate debts ($6 billion, col. 58) and attorneys' and executors' fees ($2 billion; col. 54 and 52, respectively). The total of all other deductions was about $1 billion.

[14] While the estate tax returns presumably provide reasonably accurate data on marital deductions and charitable gifts, they are highly unreliable on the question of the total wealth transferred. As will be seen in the balance of this paper, virtually all avoidance devices either take value out of the estate altogether (such as insurance trusts), or reduce the valuation of the property, in many cases below what would appear to be an appropriate market valuation (such as family partnerships). What is reported as the gross estate on the estate tax return, unfortunately, is actually a net number that is reached after estate planners have implemented their avoidance strategies.

by 1924, when Congress finally enacted the first gift tax.[15] For roughly the next half-century, the estate and gift taxes proceeded in parallel but along separate courses, with each having its own exemptions and rate structures. The absence of coordination between the two taxes encouraged wealthy individuals to make sizable gifts during life, to use up the gift-tax exemption and the lower ranges of the gift tax rates, because the advantages of those features would be lost once the individual died.

Congress unified the estate and gift taxes in the Tax Reform Act of 1976, creating more or less the structure that prevails to this date. Under the unified structure, lifetime gifts are accumulated, and only become taxable when the $675,000 that is protected by the unified credit is exhausted. Once exhausted through lifetime gifts, the unified credit is no longer available to shelter subsequent transfers during life, nor transfers at the decedent's death. If partially exhausted due to lifetime gifts, the credit is reduced to that extent. Under this structure, a transfer of a given amount from one generation to the next will generally produce the same dollar value of transfer tax liability regardless of whether some or all of that value was transferred during the decedent's life, or exclusively at death.[16]

Like the estate tax, the gift tax was intended to reach broadly all gratuitous property transfers,

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[15] That gift tax was repealed a year later; however, in 1932 Congress enacted another gift tax that has, with important modifications from time to time, been continuously in force in subsequent years.

[16] This is not to say that all incentives for lifetime giving have been eliminated; as will be discussed below, substantial advantages continue to be available to wealthy people who are willing to part with their property in advance of their deaths. In particular, because the gift tax is the legal liability of the donor, payment of the tax depletes the estate to that degree; effectively, then, there is an estate-tax deduction for gift taxes paid, as well as a credit in the computation of the unified estate and gift tax.

whether direct or indirect. For example, if a corporation sells property for less than its value to a relative of a major shareholder, the arrangement is subject to recharacterization as a dividend to the shareholder, followed by a potentially taxable gift from the shareholder to the relative.[17] Similarly, arrangements such as interest-free loans may create taxable gifts.[18]

Also like the estate tax, the gift tax permits unlimited deductions for gifts to spouses and charitable entities.[19] In addition, the gift tax rules permit an "annual exclusion" of gifts of up to $10,000 in value to any donee during any year.[20] Married taxpayers can, with the consent of both spouses, claim exclusions for gifts of up to $20,000 per year, per donee, regardless of which spouse is the source of the gifted property.[21] This exclusion is subject to one important caveat, however: gifts will not qualify for the annual exclusion if they are gifts of "future interests."[22] An explanation of this concept, and a discussion of its implications in estate planning, are offered below in the section on use of the annual exclusion. And, though the point is an obvious one, it is so important

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[17] Such recharacterization would depend on a number of circumstances, and would never be automatic. A case in which precisely these facts were presented is Epstein v. Comm'r, 53 T.C. 459 (1969). (Note that a gift is only potentially taxable, because it may be within the donor's lifetime exemption, or eligible for the annual exclusion from the gift tax explained immediately below.)

[18] This rule was first determined by the Supreme Court, in Dickman v. Comm'r, 465 U.S. 330 (1984). The rule was subsequently codified by Congress in IRC sec. 7872, added to the Code later the same year.

[19] IRC sec. 2523 and 2522, respectively.

[20] IRC sec. 2503(b). The $10,000 amount is to be adjusted, pursuant to sec. 2503(b)(2), in $1000 increments, to reflect inflation after 1998; no such adjustment has been required to date.

[21] IRC sec. 2513.

[22] IRC sec. 2503(b)(1).

that it should be emphasized: while the exclusion is part of the gift tax provisions, it is effectively an exclusion for estate-tax purposes as well, since any funds transferred irrevocably during life will not be present in the gross estate when the estate tax liability is computed. Similarly, subsequent earnings generated by property given away during the testator's life will also fall wholly outside the gross estate.

3. Trusts – Because many of the estate planning devices to be described involve the use of trusts, a few words about trust terminology may be helpful to non-lawyers. A trust is a legal entity created by one or more grantors (sometimes called settlors) to hold and manage property for the benefit of one or more beneficiaries (which can include the grantor). The property transferred to a trust may be referred to as its principal, or corpus, which is to be distinguished from the income generated by the corpus while it is held in trust. Trust documents typically instruct the trustees (who are responsible for managing the trust property, and protecting the rights of the beneficiaries) to distribute income periodically to particular beneficiaries (who are said to have income interests in the trust), and to preserve the corpus for distribution at the conclusion of the trust term to other beneficiaries (who are said to have remainder interests in the trust). However, trusts can be designed to accumulate some or all income, or to permit invasion of corpus, either generally or for specific purposes. Trusts can be created for a term of specific duration, or for the lifetime of one or more individuals (usually the grantor or a beneficiary). Trusts are usually irrevocable, in which case transfers of assets to the trust are treated as complete for most tax purposes; but trusts can be revocable if the trust agreement so provides, meaning that the grantor can cause the return of the assets to himself by simply choosing to cancel the trust agreement. The assets in a revocable trust

are generally treated for tax purposes as belonging to the grantor. The income tax treatment of trusts is governed by subchapter J of the IRC (sections 641 through 692, inclusive), and can be quite complex. Depending on the provisions of the trust and the actions of the trustees, the income generated by the corpus in the trust may be taxable to the grantor, the beneficiaries, or the trust itself.

4. The Federal Generation-Skipping Transfer Tax – Prior to 1976, there were transfer-tax advantages associated with trusts that would leave an income interest in the trust to one (or more) of the decedent's children, for the duration of that beneficiary's life, with a remainder interest to be paid to one or more of the decedent's grandchildren. The transfer of property into the trust from the grandparent's estate would be a taxable transfer by the deceased grandparent, but the enjoyment of the remainder interest by the grandchildren at the death of the member(s) of the intermediate generation was not generally subject to a transfer tax. This was typically true even if the trustees had some powers to invade the corpus of the trust for the benefit of the member(s) of the intermediate generation. If the testator so chose, more than one generation could be skipped; that is, a trust could create a series of lifetime income interests cascading down through subsequent generations, each one beginning tax-free at the death of a member of the previous generation, with a remainder interest vesting in a member of the fourth or fifth generation following the testator whose will created the trust.[23] A majority of Congress in 1976 believed that the enjoyment of the value of the property by

[23] Historically, trusts could not endure indefinitely as a matter of law. Most states limited the duration of trusts by some variant of the "rule against perpetuities," which generally requires that the interests created by the trust must vest within a period measured by the duration of any life existing at the time the trust is created, plus 21 years. See generally the William Hurt/Kathleen Turner film Body Heat, which is thought to be the cinematic debut of this wonderful common law concept. Some form of this rule, which effectively limits trusts to four or five generations, in most cases, continues to apply in most states. However, a handful of states

the intermediate generation(s) was sufficient that the passage of value from each generation to the next should be subject to a federal transfer tax. Accordingly, they created the aptly named "generation-skipping transfer tax" ("GST tax") in that year.[24]

The GST tax can be quite complex, but essentially it treats the termination of the life interests of any intermediate generation in a situation of the sort described (or certain others deemed equivalent by Congress) as a taxable event, effectively imputing the value of the interest passing to the next generation as a part of the estate of the member of the intermediate generation. The GST tax also taxes certain "direct skips" that do not pass through the intermediate generation. The saving grace of the GST tax is that it only applies to transfers within its ambit to the extent that they exceed $1,030,000 per transferor.[25] Largely because of the generous exemption, the GST tax collects very little revenue–about $86 million in 1997, or about half of one percent of the total federal transfer tax collections.[26] However, it is one of those taxes–rather like the alternative minimum tax–whose impact is to discourage taxpayer behavior by imposing strong disincentives. To the extent that the tax succeeds in this effort, its effects would not be reflected in the revenue collected, but rather in the generation-skipping bequests that it discourages. While the latter is not easily measured, the point is that the GST tax should not be regarded as unimportant simply because of its negligible

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have recently abolished their versions of the rule against perpetuities, and institutions in some of those states (Delaware and Alaska seem to be particularly prominent) have begun actively marketing so-called "dynasty trusts" that exploit the absence of such limitations. See the discussion of this device infra at section B.7.

[24] IRC sec. 2601 et seq.

[25] IRC sec. 2631(a). The figure in the text is for the year 2000. The exemption level is now indexed, and may be adjusted in subsequent years.

[26] Johnson and Mikow, supra, note 12, at 108. (Table 1c., col. 86.)

revenue impact.

B. The Avoidance Options

With that background on the tax landscape faced by wealthy individuals and their advisors, we can proceed to a discussion of several of the more important avoidance options. As will be seen, some of these result in the removal of transfers from the transfer tax base altogether. Others operate primarily to diminish the tax value of the assets included, either by exposing the transfer to tax at a time when the value of the transferred interest is low, or by achieving in some other way a valuation that understates somewhat the likely true value of the property transferred. For the most part, each of these options is self-sufficient;[27] accordingly, they can be discussed seriatim, beginning with the three options that are based on the major deductions or exclusions from the estate and gift tax, namely, the annual exclusion, the charitable deduction, and the marital deduction.

1. Use of the Annual Exclusion – By far the simplest strategy available to wealthy individuals who wish to make tax-free transfers to subsequent generations involves the committed, regular use of the annual exclusion. A typical married couple in their fifties, for example, may have two children, each of whom may have a spouse, as well as two children of their own. Each of these eight potential beneficiaries could be given, free of any transfer tax, $20,000 per year. Over a period of 20 years (well within the life expectancies of the couple), this practice would distribute over $3 million to subsequent generations without giving rise to any transfer taxes at any time. If one

[27] Many of the devices can be combined in one way or another with other devices. For example, many of the devices involve creation of trusts; and a trust can contain a wide range of assets, some of which could consist of such things as units in a family limited partnership.

considers as well the income produced by the funds given away in this manner (which will enrich the donees, rather than augmenting the estate), the potential reduction in the estate would be around $5 million altogether from the strategy outlined, assuming a 6% rate of return. If the family is larger, or if the donors either live longer or are willing to spread their largesse more widely (for example, to nieces, nephews, cousins, etc.), then this sum could of course be much larger. One recent study suggested that roughly one-quarter of the wealth transfers between succeeding generations could be sheltered from transfer taxes using this simple device.[28] This device is also nearly free of the transactions costs that commonly accompany more complicated estate-reduction devices. The donors need only open their checkbook once a year and make the transfers. If all gifts during the year are within the annual exclusions for each donee, then it is not even necessary to file a gift tax return.[29]

Despite the obvious tax-avoidance efficacy of a strategy making maximum use of the annual exclusion, few people pursue the strategy to the fullest degree possible. In the aggregate, it is estimated that, at most, only about 15% of the value of the annual exclusion gifts that could be made tax free from potentially taxable estates are in fact made.[30] A number of explanations have been offered. In the case of estates that are in the low seven-figure range, a plausible claim can be made

[28] J. Poterba, "The Estate Tax and After-Tax Investment Returns," at 24. Univ. of Michigan Office of Tax Policy Research Working Paper Series, No. 98-11 (1998). (The paper presents a variety of estimates, ranging from 22 to 33 percent, depending on the underlying assumptions.)

[29] IRC sec. 6019(1).

[30] Poterba, supra, note 28, at 25. (Poterba estimates that annual giving levels within the annual exclusion could be approximately $443 billion; estimates of actual gifts qualifying for the annual exclusion vary, but no estimate is higher than about $62 billion.)

that the potential donors feel a need to retain all or most of their assets as protection against catastrophic medical expenses, rampant inflation, and other uncertainties that they may face. Other prominent explanations include the possible damage done to young donees who may in some cases receive as much (or more) by gift as they are able to earn on their own in the labor force,[31] and the possibility that testators prefer to retain their assets until death as a way of retaining some amount of control over the behavior of their children and others who imagine themselves to be, eventually, targets of bequests.[32] But some observers have forcefully argued that the real barrier to full use of the annual exclusion has to do with the strong preferences of potential donors for the retention of economic power.[33]

Gifts to a minor can generally qualify for the annual exclusion even if the value of the gifts is not made immediately available to the child. Under the provisions of the Uniform Transfers to

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[31]Note that if both parents and as many as four grandparents make the maximum tax-free gifts, a child/grandchild could receive up to $60,000 per year from this source. As will be explained below, however, the present interest requirement of the annual exclusion operates somewhat differently in the case of gifts to minor children; so concerns about the ability of a child to exercise wise stewardship over gifts of this magnitude do not present any genuine obstacles. Such gifts may, however, because of the fiduciary relationships involved, have somewhat higher transactions costs.

[32] Bernheim, Shleifer, and Summers, "The Strategic Bequest Motive," 93 J. Pol. Econ. 1045, 1076 (1985). Still other explanations, having to do with the possibilities that the older generation may have more attractive investment opportunities; that they may lack sufficient liquidity to make lifetime gifts; or that they are reluctant to forgo the stepped-up basis opportunities provided by IRC sec. 1014 for assets held at death, are considered in Poterba, "Estate Tax Avoidance by High Net Worth Households: Why Are There so Few Tax-Free Gifts?," J. of Private Portfolio Management, Summer, 1998, at 1, 7-8.

[33] See, e.g., L. Thurow, Generating Inequality, 139-142 (1975). (Thurow was speaking principally of the then greater tax advantages associated with lifetime giving under the pre-1976, pre-unified, estate and gift tax system. However, his observations would seem to have equal relevance to the use of the annual exclusion.)

Minors Act ("UTMA"), which has been enacted in some form in most states, the transfer is made to a custodian who holds the assets for the child until the child reaches age 21.[34] The donor can be the custodian of a gift to a minor, but if the donor dies during the custodianship period, the assets will typically be included in the donor/custodian's estate as a revocable transfer.[35] Thus, the regular use of the annual exclusion in making gifts to minors as an estate planning device is advanced more reliably by designating as custodian someone other than the donor. By means of regular use of the annual exclusion, a married couple could thus transfer up to $420,000 to each child free of any transfer taxes (21 years times $20,000 per year), as could each pair of grandparents, if they survive to the age of majority of their grandchildren.

Of course, the possibility that a child/grandchild might enjoy a birthday gift of $1,260,000 or more upon attaining the age of 21 is not something that every family regards as desirable.[36] To avoid this possibility, while retaining as much as possible of the benefits of regular use of the annual exclusion, many donors resort to so-called "Crummey trusts,"[37] a name which sounds pejorative,

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[34] The relevant age of majority is one of the several ways in which each state's version of this model legislation may vary. In several states, the age of majority for UTMA purposes is 18, rather than 21.

[35] IRC sec. 2038. Even though the gifts in such cases are not in fact revocable, this provision has been interpreted broadly to authorize inclusion in the estate because of the retained power of the grantor to affect the timing of the benefit to the minor child. See, e.g., Lober v. U.S., 346 U.S. 335 (1953) (interpreting predecessor provision under the 1939 Code); Rev. Rul 57-366, 1957-2 C.B. 618.

[36] This assumes that each parent, and each of four grandparents, made the maximum excludable gift during each year of the child's minority. If no distributions had been made from the trust, the accumulated earnings would of course make the hypothetical gift much larger.

[37] These trusts take their name from the case in which their use was first fully endorsed by the courts, Crummey v. Comm'r, 397 F.2d 82 (9th Cir., 1968).

but is so perhaps only to the IRS. Under a Crummey trust, the beneficiary is given a power (a "Crummey power") to demand distribution of each year's contribution by the donor to the trust; but if the power is not exercised within a reasonable time, then the power lapses.[38] The reasonable time can apparently be quite short; in one case litigated on other issues, the IRS did not challenge the validity of Crummey powers that could only be exercised within fifteen days.[39] Though Crummey trusts thus do involve the possibility of limited invasion of the trust corpus by the beneficiary, it must be presumed that those beneficiaries understand that to exercise their rights to demand immediate distributions contrary to the donor's wishes would jeopardize future contributions to the trust, and are for that reason willing to accede to the donor's wish to allow the trust to accumulate, all the while making regular use of the annual exclusion.[40]

A number of other devices involve the use of the annual exclusion to pass partial interests in property each year to the next generation, but they will be explained subsequently as each of those devices is outlined.

2. Charitable Gifts -- At the most basic level, a simple cash bequest to a charitable

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[38] The limited power to demand distribution transforms what would otherwise be a future interest into a present interest, which in turn qualifies the annual contribution to the trust for the annual exclusion.

[39] Cristofani Est. v. Comm'r, 97 T.C. 74 (1991). The estate planners interviewed for this paper recommended periods of at least 30 days, and some preferred exercise periods of up to one year. Also, reasonable notice of their rights to distributions from the trust should be provided to the beneficiaries if the annual exclusion is to protect the transfer from gift tax liability, though there is some precedent to the effect that actual notice is not legally necessary. (See Estate of Holland v. U.S., T.C. Mem. 1997-302.)

[40] Only two of the estate-planner interviewees had ever witnessed an actual exercise of a Crummey power, and one of these knew of only a single instance.

organization will eliminate the tax that would have been paid on that amount had it been left to noncharitable beneficiaries. The cost of such gifts may accordingly be formulated as the gift itself times one minus the marginal tax rate, which–in view of marginal rates ranging from 37 to 60%–yields a cost ranging from 63 cents on the dollar to as little as 40 cents on the dollar.

An even lower after-tax cost of giving can be achieved if gifts are made during the donor's life, however, because of the income tax deductions available for such gifts.[41] A donor who is in the highest rate bracket as to both the income and estate taxes can achieve an after-tax cost of giving as low as 24 cents on the dollar; that is to say that a dollar given during the donor's life to charity may cost the heirs as little as 24 cents in lost net inheritance.[42] This tax arithmetic makes clear that

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[41] Some very high-wealth taxpayers get little or no income tax benefit from charitable giving because of the limits of IRC sec. 170(b), which allows deductions only up to an amount equal to fifty percent (or less in some cases) of the taxpayer's "contribution base," which is essentially the taxpayer's adjusted gross income. An individual whose wealth is largely in the form of highly appreciated (but as yet untaxed) assets, such as the stock of company created by the taxpayer, may have the willingness and capacity to make gifts that greatly exceed this level, but he will have to do so without benefit of an income tax deduction. (Unused deductions may be carried over for up to five years; even so, some high-wealth individuals find themselves in a persistent situation of having contributions that exceed the annual limits, and thus never have years in which carried over deductions from prior years can be claimed.)

[42] Had the dollar of income not been sheltered from income tax by the charitable deduction, only a bit more than 60 cents would have remained after that tax had been paid. The 60 cents remaining in the estate would have incurred a further estate tax liability as high as 60 x .6, or 36 cents. Thus, the 40 cents of income tax savings, plus the 36 cents of estate tax savings, leave a net cost of only 24 cents lost by the heirs for every dollar given to charity during the donor/testator's life. (Note, however, that the usual reduction in the cost of giving associated with gifts of appreciated property ordinarily does not apply in the estate planning context. That reduction involves the implicit assumption that, in addition to ordinary income sheltering, there is a sheltering of the income tax on the capital gain that would have been incurred had the appreciated asset been sold. However, because heirs who receive property take that property with a basis equal to the fair market value of the property as of the date of death (or the alternate valuation date) pursuant to IRC sec. 1014, there is no capital gains tax to be avoided as to the unrealized gain on appreciated property. Thus, a charitable gift of appreciated property that would otherwise be retained until death neither adds to nor subtracts from the tax advantages of

lifetime charitable giving has nearly as much to do with estate tax avoidance as it does with income tax considerations, particularly for elderly donors or others of limited life expectancy.

Of course, simple cash bequests do not exhaust the estate planner's repertory in the charitable giving area. There are a number of interesting options having to do generally with split-interest gifts, in which an income interest of one sort or another is given to one party, and a remainder interest to another. If either party is a charitable entity, there will be either income tax or transfer tax advantages (or both) associated with the gift.

There is a family of similar transactions, under which the charitable entity receives a remainder interest, that are typically known by their acronyms: CRATs, and CRUTs–charitable remainder annuity trusts, and unitrusts, respectively. These involve a gift from a donor (usually during the donor's life) to a trust, which distributes income from the trust to the donor or another noncharitable party for either a period of years or for a period measured by the life of a natural person (typically the donor), following which the corpus of the trust is distributed to a charitable entity. The actuarial value of the remainder given to charity is deductible from income taxes by the donor in the year the assets are irrevocably transferred into the trust; the estate tax benefit comes simply from the removal of the entire corpus of the trust from the taxable estate. Although quite popular estate planning tools, these vehicles will not be further detailed in this paper because the benefits associated with these instruments are thought to involve primarily avoidance of income taxes.[43] From an estate tax perspective, they typically do not accomplish much more than a

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charitable giving.)

[43] In particular, these devices can provide an attractive means of diversifying a concentrated portfolio of appreciated assets. Because the trust is itself tax exempt, it can liquidate appreciated assets without immediate tax consequences, the proceeds of which can then

straightforward, noncharitable annuity contract might.

Estate tax considerations are more important in the other sort of split-interest charitable gift, the charitable lead trust. In this vehicle, the donor transfers assets to a trust with instructions to pay an income interest to a charitable entity, with the remainder interest being distributed at the end of the trust term to a noncharitable beneficiary. The income interest can be given either in the form of a guaranteed annuity (a charitable lead annuity trust), or in the form of a fixed percentage of the annually appraised fair market value of the assets in the trust (a charitable lead unitrust). Although the donor may usually deduct for income tax purposes the actuarial value of the income interest given to charity, the tax benefit of this deduction is offset by the requirement that the donor include the trust income going to charity in later years in the donor's own adjusted gross income.[44] This is an appropriate income tax result, in that the charitable lead trust effectively replicates what would happen if a donor had simply received investment income and then transferred that income each year to a charitable entity; the charitable deduction would offset the investment income, but would not shelter any other income.[45]

The transfer tax benefit of the charitable lead trust is that it transfers assets into the hands of

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be invested in a diversified portfolio to provide, for example, a secure stream of retirement income to the donor.

[44] Both clauses of this sentence presume that the trust will be structured as a grantor trust. If the trust is structured instead as a nongrantor trust, then the initial deduction is unavailable, but so also is the subsequent trust income excludable.

[45] Charitable lead trusts can have favorable income tax consequences in some cases, however. In particular, if the donor's tax bracket is expected to decline in future years, then benefit of the immediate deduction of the discounted present value of the future income going to charity will not be fully offset by the subsequent inclusion of that income in the taxpayer's taxable income in future years.

the ultimate beneficiaries at reduced values. The charitable lead trust is considered to be a taxable transfer to the beneficiary at the time the assets are transferred into trust, in an amount equal to the difference between the value of the assets and the value of the charitable income interest. Thus, a gift of trust assets consisting in substantial part of growth stocks[46] might be valued for transfer tax purposes at a fraction of its present value as of the date of the gift (because of the reduction for the charitable interest), but the entire value of the corpus (which would be expected to have grown because of the corporate earnings reinvestment strategy) can be passed without additional transfer tax consequences to the ultimate donee at the end of the trust term or the end of the measuring life (typically the donor's).

By itself, this is not very different from the results that could be obtained by simply dividing the trust corpus into a share that would go directly and immediately to charity (generating a charitable deduction of that amount), and another share that would go directly and immediately to the noncharitable beneficiary (generating a taxable gift of that amount); if invested in the same way that the trustees would have, the latter share would grow to the same amount that would constitute the expected remainder interest at the termination of the lead trust, with similar tax consequences.[47] Again, however, estate planners frequently encounter a preference on the part of donors to defer the full enjoyment of their gifts, both charitable and familial. On the charitable side, an income interest assures that the gift will have the endowment-like quality that many charitable donors seem to prefer;

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[46] The donor will typically wish to include some income-producing assets to enable the trust to discharge the obligations to the charitable donee without liquidation of significant trust assets.

[47] In the direct gift alternative described here, much or all of the corpus would presumably be invested in growth stocks, so that the donee could benefit from the favorable effects of the deferral of income taxation on unrealized appreciation.

on the familial side, the enjoyment of the gift can be deferred until the donee has acquired the maturity to handle responsibly the receipt of the wealth in question.[48]

While charitable split-interest gifts can accomplish significant transfers of value to charities, they have also been subject to a good deal of abuse in recent years. Schemes involving charitable remainder trusts using very high payout rates produce mostly income-tax avoidance; descriptions appearing elsewhere will not be repeated here.[49] But a very recently developed form of aggressive transfer tax avoidance involves the use of charitable lead trusts. This device–like many in this area--exploits the fact that the valuation of remainder interests is usually based on tabular life expectancies applied to the "measuring life" of the income interest. Under a so-called "vulture trust," the grantor would employ as a measuring life the life of a person–typically a stranger recruited for this purpose by the "vulture"–who was suffering from AIDS, or some similar condition having radically depressing effects on life expectancy. Thus, a 35 year-old person with a tabular remaining life expectancy of perhaps 40 years, but an actual remaining life expectancy of perhaps two to five years, would be used as the measuring life. This would establish a very low value for the remainder interest, because the actuarial expectation would be that the death of the person whose life was the

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[48] Because the death of a parent frequently occurs when the children are in middle age, the intention of the donor/testator is frequently to provide a store of wealth adequate to assure the children's comfortable retirement.

[49]Congress addressed some of the more serious abuses in this area by amending IRC sec. 664 in the Taxpayer Relief Act of 1997. For a brief explanation of these devices, see IRS Notice 94-78, 1994-2 CB 555, and G. Auten, C. Clotfelter, and R. Schmalbeck, "Charitable Giving Among the Wealthy," at 12-15, Univ. of Michigan Office of Tax Policy Research working paper 98-15 (1998).

measuring stick would not occur for many years.[50] In fact, that measuring life is chosen precisely because the individual's death is close at hand; and when it does occur a few years later, very large values could pass--free of any additional transfer tax--to the non-charitable remainderman. The IRS has (probably) shut down this abusive use of charitable lead trusts by proposing regulations that would limit the selection of measuring lives to close relatives.[51] But this egregious device remains an instructive illustration of a pattern that runs through a number of the devices to be described herein: the use of tabular assumptions as to life expectancy and rates of return that allow individuals to engage in various adverse selection games that employ the tabular rates when they are helpful, while avoiding them when they are not.

One cannot conclude the discussion of the charitable area without noting that several estate planners–especially those with the most experience with very large estates–mentioned the continuing high level of interest in setting up private foundations. Again, nothing particularly fancy in the way of tax avoidance is involved in establishing a private foundation; such gifts are simply another form of charitable contribution, and thus qualify for deductions from the income, gift, and estate tax bases. Their desirability comes from the opportunity they provide to wealthy donors (or their designates) to retain a good deal of control over the assets of the foundation (which may be, for example, stock of a family corporation, though this is subject to a number of restrictions[52]), and control as well over the direction of the income from those assets to the ultimate charitable

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[50] For example, at a 6% discount rate, a remainder interest that would not ripen for 40 years would have a value equal to about 9.7% of the value of the corpus.

[51] See 87 Tax Notes 207 (4/10/00), which describes proposed amendments to the Treas. Regs. sec. 25.2522(c) that would restrict the choice of measuring lives.

[52] See generally the rules on excess business holdings, IRC sec. 4943.

beneficiaries funded by the foundation's grants. There are some drawbacks to foundations, which include the exposure to the elaborate array of excise taxes applying to such organizations, and the fact that, for income tax purposes, there is a limitation on the percentage of gross income that can be deducted for gifts to foundations (generally 30% rather than 50% for public charities), and limitations on the ability to deduct the fair market value of appreciated property (generally, only certain publicly traded stock can be deducted at full value when given to a private foundation) rather than being limited to the property's tax basis. However, neither of these drawbacks come into play in the estate and gift tax area; all gifts to charitable entities–whether public charities or private foundations--are fully deductible.

3. Marital Deductions –Federal transfer taxes apply separately to each natural person, and allow each decedent both a substantial exemption and the benefit of lower marginal tax rates on the first $3,000,000 transferred. When an unlimited marital deduction is added to these structural features, a basic tax-minimization strategy is immediately evident: estate plans for married couples should at a minimum be structured to assure that the full value of both exemptions can be claimed. By doing so, the estate plan assures that the married couple enjoys an effective exemption of $1,350,000. Under some circumstances, they may wish to assure as well that the couple's wealth makes two trips through the lower rate brackets, thus insulating their estates from the highest rates on the first $6,000,000 transferred, regardless of the division of wealth between them.[53]

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[53] The benefits of taking two credits, and two trips through the rate brackets, can be considerable. As an illustration, a $6,000,000 taxable estate would generate an estate tax liability, after allowance of the unified credit, of $2,720,250. Two $3,000,000 estates, in contrast, would generate a total tax liability of only $2,140,500, thus saving $579,750, or 21.3% of the liability that would be incurred on a single estate of $6,000,000. Of this savings, $220,550

For smaller to medium-sized taxable estates (in perhaps the two to ten-million-dollar range) assuring effective use of both unified credits is the estate planner's first step. Because it is again true that even the simplest strategies in this area can be highly effective, a few minutes of skilled draftsmanship can produce transfer tax savings of hundreds of thousands of dollars in many cases. Ideally, any transfers necessary to assure that each spouse makes full use of the unified credit would be done during life, since a partner with little or no wealth may die first, leaving the surviving spouse with all or most of the wealth, but no one qualified to receive a marital deduction gift.[54] But, though exceptions abound, the husband is generally the wealthier and older member of the couple, and possessed of a shorter overall life expectancy as well. Under those circumstances, it may suffice simply to assure that a husband in such a situation has a will that passes substantial assets to his wife, so that she may take full advantage of the unified credit.

Problems can arise, however, in trying to make the best use of the two credits when the tax-minimization strategy is not completely harmonious with the dispositive preferences of the couple. For example, in small to medium estates, and especially where the marriage is a stable first marriage

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is generated by the availability of the second credit, and the balance by the lower rates on the first $3,000,000 transferred. On the other hand, intentionally exposing half of the total value of the couple's wealth to an estate tax at the death of the first to die may not always be the best strategy. If the surviving spouse is in good health, any estate tax potentially owed at the first death can be deferred indefinitely by making sure that the marital deduction shields all but the amount that can be absorbed by the unified credit. In fact, the surviving spouse may not only be able to defer the tax by continuing to live, but may also be able to use the annual exclusion, for example, in subsequent years to transfer much of the potential estate to the next generation free of any transfer tax. The couple will not know, of course, when their wills are drafted, the ages at which each will die. But it is probably sensible when the testators are relatively young to pursue a strategy that makes maximum use of the marital deduction, thus deferring any tax that might fall due if one of them dies prematurely.

[54] Although widowhood is a correctable condition, couples engaged in estate planning do not typically wish to explore the ramifications of that notion in any great detail.

for both parties, the couple's first instinct is often to leave all of the estate to the surviving spouse. If they do so, the estate of the first to die will receive no benefit from the unified credit because the marital deduction will reduce the taxable estate to zero. At the other end of the spectrum of preferences, someone who remarries late in life may wish to leave all or most of the estate to children of a prior marriage, and may not want to leave enough to a surviving spouse to enable him or her to use the full measure of the unified credit (or the lower rate brackets) at the death of the second to die.

To a limited degree, either of these preferences can be accommodated at only modest loss in the value of the double-credit strategy. If the preference is to leave as much to the spouse as possible, but still to create enough of a taxable estate at the first death to absorb the credit (and the lower rates, if desired), property can be left to a "credit shelter trust" that may pay the surviving spouse an income interest for life (or, less expansively, merely permit invasion of corpus if needed for support of the surviving spouse), with a remainder interest to one or more children, with the specific intention that income interest passing to the spouse would nevertheless <u>not</u> be marital deduction property. The trust corpus will then be included in the estate of the first spouse to die, and will pass to the next generation without inclusion in the estate of the surviving spouse.

If the situation is the reverse–that is, if the desire is to leave less to the surviving spouse than the amount that would be necessary to allow the spouse fully to absorb the credit and the lower rates at his or her death–then the standard approach would be to set up a "qualified terminable interest property trust," known in the trade as a "QTIP" trust.[55] This is a trust over which the surviving

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[55] The desire to leave less to a surviving spouse than the amount necessary to absorb the credit may be frustrated by state laws requiring "forced shares" of estates to go to surviving spouses. This will depend on the size of the estate, the particulars of state law, the presence and content of an antenuptial agreement, and other circumstances.

spouse has just enough rights to the income from the trust to qualify the transfer of property to the trust for the marital deduction (taking it out of the first estate for tax purposes), with the ancillary consequence of being includable in the estate of the surviving spouse at the time of that later death. The income rights necessary to qualify a QTIP trust are fairly detailed,[56] but they include such things as a requirement of at least annual payments of the trust income, a bar on investment of the corpus in unproductive property without the surviving spouse's consent, and other similar measures designed to assure that the right to the income from the trust cannot be easily defeated by a testator whose real preference is to leave as much as possible to the children or other beneficiaries than the surviving spouse. Arrangements other than QTIP trusts also are available to accomplish the purposes of making sure that an appropriate share of the couple's total wealth is taxed at the death of the second to die, such as the marital deduction power of appointment trust, and certain types of legal life estates outside of a trust situation.

Credit-shelter and QTIP trusts, and other, similar devices are widely used, and certainly have the effect of reducing transfer taxes, compared with some alternative disposition patterns that could be reasonably imagined. Whether this makes them "tax-avoidance devices" depends on what is meant by that phrase. This is particularly worth noting in this context, because Congress was very well aware of what actions it was sanctioning when it added the QTIP provisions to the Code in 1981, as part of the expansion of the marital deduction. Creation of an unlimited marital deduction without things like a QTIP trust would have imposed unduly harsh choices, in Congressional eyes,

[56] See IRC sec. 2056(b)(7), and the regulations promulgated thereunder, for fuller details.

between tax avoidance and dispositive preferences.[57] In light of their fairly explicit invitation to manipulate the marital deduction in this way, QTIP trusts and similar vehicles might be better viewed as simply features of the transfer tax system, rather than the creation of fertile minds bent subverting Congressional intent.

4. Insurance Trusts – Life insurance proceeds on a decedent's life that are payable to the estate or to beneficiaries named by the decedent are ordinarily included in the decedent's gross estate.[58] However this result can be reversed if the decedent had no "incidents of ownership" of the policies at the time of his death.[59] This rule has led to the widespread use of insurance trusts, to which the insured has either transferred ownership of the policies, or funds with which to purchase the policies. If certain formalities are observed, it is not difficult to make the trust the owner of the policies rather than the person whose life is insured, thereby accomplishing the quite wonderful

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[57] As the Ways and Means Committee report put it: "[U]nless certain interests which do not grant the spouse total control are eligible for the unlimited marital deduction, a decedent would be forced to choose between surrendering control of the entire estate to avoid imposition of estate tax at his death, or reducing his tax benefits at his death to insure inheritance by the children. The committee believes that . . . tax consequences should not control an individual's disposition of property." H.R. Rep No. 201, 97th Cong., 1st Sess., reprinted in 1981-2 C.B. 352, 377-78. There is no evidence of any conscious irony in this last sentence.

[58] IRC sec. 2042.

[59] Before 1981, transfers within three years of death were routinely brought back into the estate for estate tax purposes under IRC sec. 2035. Since that year, those rules apply to a much more limited range of property; however, property that would have been included in an estate as proceeds of life insurance remains subject to the three-year rule. Therefore, if the decedent dies lacking incidents of ownership because he has transferred them within the three-year period preceding his death, the proceeds will be included in his estate under IRC sec. 2035. Conversely, if the incidents of ownership lapse without action on the part of the decedent within the three years immediately prior to his death, then the insurance will not be brought back into the estate..

result of entirely removing the proceeds of the policies from the gross estate. Insurance trusts are especially useful in providing indirect liquidity to an estate, since the relatively small investment values in the policy become much larger when the insured's death triggers payment of the (nontaxable) proceeds.

The transfer to the trust of either the policies themselves or funds to pay premiums to purchase or maintain the insurance can create gift tax liabilities if the value of the policy is large. However, it is frequently possible to use the annual exclusion to avoid all or most of those liabilities, especially if the trust has multiple beneficiaries among whom the gift would be spread. The use of Crummey powers[60] is common to assure that the gifts qualify as present interests for purposes of the gift tax annual exclusion. Under such an approach, cash for each year's premium may be transferred to the trust, with notice to the beneficiaries of their rights to withdraw all or part of the newly transferred amount. If and when the withdrawal right lapses (which can be within a few weeks), the funds are transferred to the insurance company to pay the premiums on the policy. Although this device is simple, powerful, and relatively foolproof, it does not appear to be well known by the general public. For that reason, it is one of the more impressive tools that an estate planner can reveal–one imagines with some flourish–to new clients. One of the unfortunate consequences, one further imagines, is to incline laymen toward a belief that virtually any kind of estate planning magic is possible, given the gross violation to common sense that tax treatment of insurance trusts exemplifies.

5. Family Limited Partnerships – A powerful tool for reducing the value subject to transfer

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[60] See description in section B.1, supra.

tax liabilities that has become increasingly popular in recent years is the family limited partnership.[61] Under this device, assets are transferred to a limited partnership whose limited partners are typically the family members of the person who creates the partnership and transfers assets to it; the general partner is often a corporation set up specifically to hold the general partnership interest. The gratuitous transfer of interests in a limited partnership–or, alternatively, the gratuitous transfer of assets to a partnership in which others already hold interests--is likely to be a gift for gift tax purposes. However, by making small transfers seriatim over a period of years, the donor may be able to use the annual exclusion to insulate much or all of the transfers from actual gift tax incidence. And, of course, at the donor's death, there is reason to hope that only the donor's share of the partnership assets would remain to be included in the estate.

From this bare-bones description, it may be difficult to infer any advantages over a simple transfer of the assets directly to the beneficiaries, without the frequently clumsy interposition of the limited partnership. There are several, however. First, there may be non-tax advantages to the partnership vehicle. The control of the assets by the general partner may permit better, and in any event more centralized, management of the assets than if they had been distributed among a number of beneficiaries who would all become co-owners of the assets. Second, there may be enhanced protection of the assets from creditors of both the donor and the donees. This depends to some degree on the various state laws governing partnerships and access to debtors' assets, but in general creditors can attach a limited partner's interest in the partnership, but not the partnership assets

[61] In many states, it is preferable to use a limited liability company ("LLC") rather than a limited partnership. The differences among limited partnerships, LLCs, and other so-called "pass-through entities" are not generally critical to the issues described in this paper, so the term "limited partnership" will be used to described this type of entity generically.

themselves; thus, creditors may be entitled to distributions as assignees of the debtor partner, but cannot require dissolution of the partnership or cessation of a partnership business.

The tax advantages–in addition to providing a convenient way of using the annual exclusion–consist mostly in the systematic undervaluation of the assets transferred by gift. Because all that the donee receives in a typical family limited partnership is a minority interest in that partnership, the value attached to that transfer is generally conceded to be much less than the proportionate interest in the value of the assets transferred to the partnership by the donor. This is nicely illustrated by a district court case from Texas, Church v. U.S.,[62] that was decided just a few months ago. In that case, a decedent had transferred, just before her death, an interest in ranch land worth about $400,000, and about $1.1 million in marketable securities, to a limited partnership. In exchange, she received an interest in a new limited partnership that was valued by the estate at just over $600,000. (The decedent's children made smaller transfers to the same partnership, and received smaller partnership interests.) The IRS argued in District Court that either the decedent's interest in the limited partnership had a true value of about $1.5 million, or, alternatively, that she had made a gift to her children in the amount of the difference between the value of the assets she contributed to the partnership and the value of the partnership interest she received in exchange. The court rebuffed both of these claims, essentially countenancing a situation in which more than half the value of Mrs. Church's assets disappeared when those assets went into partnership solution.

Most cases do not go quite as far, and this one may be reversed on appeal. But there is a sense among practitioners that deep discounts in valuation are appropriate, because the assets have

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[62] 2000 U.S.Dist. LEXIS 714 (Jan. 18, 2000). [Insert official citation to Fed. Supp Rptr. when available.]

been moved from a direct ownership situation to a mediated ownership situation that outside buyers would find much less attractive. A ranch, this reasoning goes, may be worth $1,000,000 if it could be purchased outright. But if that ranch is contributed to a limited partnership, and a 10% interest in that limited partnership is given to the child of the previous owner of the ranch, appropriate valuation of that interest should recognize it could not be readily marketed at anything approaching its $100,000 proportionate value.

What is the appropriate discount in such a situation? There is no firm guidance to be had on this question. Interviews with practitioners indicated that it was well known in the trade that appraisers at one large national bank routinely give appraisals that reflect 40% discounts from the value of the assets in the limited partnerships (as long as the interest was a minority interest), while appraisers working for another major bank are known to appraise at even larger discounts. It was asserted that even the IRS would allow discounts in the 10-20% range without any dispute. And, generally, the east coast practitioners interviewed for this paper believe that the approach in this region is relatively conservative, and that appraisals in Texas (obviously viewed as a renegade state for these purposes) are often as high as 80%.[63]

Although practitioners vary in their discount comfort levels, all but one seemed to feel that sizable discounts are appropriate.[64] An observer outside the system is likely to find them rather

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[63] The discount found by the appraiser (and approved by the court) in the Church case was just under 58%; but this is apparently not the maximum to be found in Texas or elsewhere. One well-known Texas estate planner has published articles that appear, by example, to endorse the idea that discounts of 65% or more might be justified in particular circumstances. See S. Eastland, "Family Limited Partnerships: Transfer Tax Benefits," Probate and Property Law Journal, Vol. 7, No. 4, at 59,61-62 (1993).

[64] The estate planners interviewed for this article seemed to regard discounts in the range of 20 to 40 or 45% as reasonable (though "defensible" was a more commonly used term),

troubling, however. The discounts put the donor/testator in the position of arguing, in effect, that a lower value should be attached to his property because he has vandalized it. He has taken assets worth $2X, and intentionally placed them into a solution that has a value of only $X. The awkwardness of this argument is exacerbated by the fact that the original assets are all still owned, however indirectly, by the same family, and that that family could, at least if they act in concert, restore the status quo ante arrangement, and its $2X value, at any time. Still, estate planners and their clients seek low appraisals, appraisers oblige them, and many courts seem willing to endorse the idea of deep discounting. This is arguably the greatest single force diminishing valuations for transfer tax purposes currently in use.[65]

Another tax advantage sometimes claimed for family limited partnerships is that if the partnership interests are distributed to family members well in advance of the donor's (expected) death, and if the assets are ones that are likely to enjoy significant appreciation during the balance of the donor's life,[66] then there can be a sizable tax advantage in having the transfer valued at a date well in advance of the testator's death. Whatever truth there is in this would also be true of direct

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depending on the circumstances, especially the type of property in the limited partnership. All of these planners, probably accurately, described themselves as conservative.

[65] For an excellent analysis of minority discounts and their impact on the transfer tax system, see James R. Repetti, "Minority Discounts: The Alchemy in Estate and Gift Taxation," 50 Tax L. Rev. 415 (1995). (Family partnership discounts are discussed specifically at 452-57.)

[66] Economists will point out that generally, an asset's value at any time reflects the reasonable market expectations about possible appreciation scenarios. But to the extent that the expected improvement in value will result from reinvested company profits, the appreciation will not necessarily be reflected in price until those profits are earned. And, of course, the availability of inside information to the executives of a corporation may give them reason to believe that significant appreciation in the market value is highly likely; if the market lacks that information, the fair market value of the stock will not reflect it.

transfers of those assets at similarly early dates; so one could say that the use of the partnership vehicle adds little to the tax-avoidance efficacy. However, the mediated form of ownership may in some cases make it easier for the donor to part with the assets in question, since the donor can continue to exercise control over the affairs of the partnership even after some significant share of the economic value of the enterprise has been passed to other members of the family, while direct transfer of the assets may make that much more difficult. This is likely to be especially important in the case of a family partnership that actually operates an active business. The partnership approach also has nontax advantages with respect to real estate interests, as it is much easier and less costly to transfer fractional shares of a real estate partnership than it is to record new deeds showing fractional ownership of the underlying real estate assets.

And, as noted, the annual exclusion can usefully leverage the advantages of the systematic undervaluation of family limited partnerships. The donor creates the partnership, and transfers substantial assets to it; then she distributes fractional interests in the partnership over several years to each of several beneficiaries, so that each such transfer is taxable, if at all, only to the extent that its (highly discounted) value exceeds $10,000. Because audits of gift tax returns are very infrequent,[67] and, since 1997, more difficult to review after the passage of three years,[68] many of

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[67] David Cay Johnston, "IRS Sees Rise in the Evasion of Gift Taxes," N.Y.Times, Apr. 2, 2000, at A1. The article relates IRS statistics that show an overall gift-tax-return audit rate of less than 1%; however, about three-quarters of the 2194 gift-tax returns filed in 1999 showing gifts in excess of $1,000,000 were audited.

[68] IRC sec. 2504(c). Before 1997, it was common to audit gift tax returns at the time of the donor's death. Since then, a three-year statute of limitations has applied to gift tax returns, as long as they fully disclose the basis for valuation of the gifts. The IRS will often be able to avoid the statute of limitations by successfully claiming defects in the disclosure. But, obviously, in at least some cases, the disclosure of even a daring undervaluation will be found by a court to have been sufficiently complete to interpose the statute of limitations as a bar to further collection of

these steep discounts will never be effectively questioned by the IRS.

Because of the complexity of the limited partnership vehicle, and the year-to-year costs of maintaining that structure, the family limited partnership is not generally promoted for estates with less than $5 million or so of wealth.[69] For estates above this figure, however, there is a good deal of activity of this sort. The most significant legal risk appears to be that the IRS will propose (and may ultimately persuade a court) that the creation of the partnership lacked business purpose, and so should be disregarded.[70] Because the achievement of centralized management is the obvious business purpose that can be asserted by estates, it is thought that assets that consist largely of small business interests or real estate–where centralized management is a logical desideratum--are reasonably resistant to such an attack. In contrast, partnerships whose assets are largely passive portfolio investments may be in some jeopardy on these grounds. Nevertheless, many family limited

transfer taxes.

[69] This was true among the group of estate planners interviewed for this article. Some of them, however, said that more aggressive planners were pushing the family partnership model even for estates that would be at the lowest end of taxability. Possibly, this inappropriately ignores the costs of maintaining the partnership vehicle; alternatively, perhaps some planners believe that they have found ways of minimizing the costs of establishing and maintaining partnerships. Note in this regard that the Church case, supra, note 62, involved a family partnership containing no more that about $1.5 million of assets.

[70] See generally Claire Toth, "The Family Limited Partnership under Siege," 59 Taxation for Accountants 346 (1997). Several practitioners noted a practical obstacle as well: the device depends on execution of documents actually transferring property to the limited partnership. Failure of testators reliably to follow through on such transactions, or otherwise to observe the niceties of the limited partnership form, have led to inclusion of some transferred assets in the estates of the transferors. See, e.g., Est. of Schauerhamer v. Comm'r, 73 T.C.M. 2855 (1997), and Est. of Reichardt v. Comm'r, 114 T.C. No. 9 (2000). [Fill in more complete cite when available.]

partnerships do apparently consist mostly or even exclusively of portfolio investments.[71] While some practitioners eschew portfolio partnerships flatly, others believe that creation of such partnerships is well within ethical bounds, and that the response to their greater riskiness lies simply in full disclosure and explanation of the risks to the client.

6. Grantor Retained Trusts – Another family of avoidance devices are the various grantor retained trusts, which, like their charitable relatives, are known by their acronyms: GRITs, GRATs, and GRUTs, for grantor retained income trusts, annuity trusts, and unitrusts. The basic form of these trusts involves establishment by a donor of an irrevocable trust, under which the donor retains an income interest for a stated period of years, while assigning the remainder interest to some named beneficiary. The present value of the remainder interest would be a taxable transfer, though the gift-tax value would of course only be a fraction of the value that will ultimately pass to the remainderman because of time-value discounting.

As in the case of the family partnership, the transfer tax advantages associated with this vehicle may not be immediately evident. The gift-tax valuation is lower, but if the lifetime exemption is exhausted, it will be currently taxable; and there is no advantage in lowering the absolute amount of a tax if the current tax is simply the present value of the larger tax that could be deferred into the future. Until 1990, however, there were significant opportunities to fund the trust with appreciating property, which diminished the actual, but not necessarily the assumed, value of

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[71] Note that in the Church case (supra, note 62) about 75% of the assets consisted of portfolio investments that were held in street name by Paine Webber; at least as to those assets, the occasional "thank you, Paine Webber" would seem to have provided all the management necessary.

the income interest. Donors also had some opportunities to engage in adverse selection if the actual facts of particular cases varied from the standard assumptions used by the IRS to value the income and remainder interests.[72]

Since 1990, however, Congress has imposed a valuation rule on grantor retained trusts that effectively values the income interest at zero (unnaturally inflating the remainder interest that is subject to the gift tax) unless the remainderman is not closely related to the donor, or the income interest retained by the grantor is a "qualified interest."[73] The non-family grantor retained trust therefore remains a viable vehicle, but only for the relatively uncommon situation involving a large gift outside of a family context.[74]

Within families, there are three important types of qualified interests now in common use. The first is a "qualified personal residence trust" (a "QPRT"), under which the grantor transfers title to a personal residence to a trust, retaining a possessory interest in the residence, but assigning the remainder to one or more donees. The second and third types of qualified transactions are simply the GRATs and GRUTs, which require that the trust fix the income interest in terms of mandatory annual payments of either a specific dollar amount (the GRAT), or a specific percentage of the trust corpus, as annually appraised (the GRUT).

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[72] In particular, it was thought that the IRS discount rates during the 1980s may have been too high. This had the effect of reducing the value assigned to the remainder interest, which was, of course, what went into the gift tax base.

[73] The rules are contained in IRC sec. 2702, and the regulations promulgated thereunder. These provisions were added by the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388.

[74] The family is defined for this purpose to include spouses, ancestors and lineal descendants, brothers and sisters, and anyone who is the spouse of any people in the foregoing categories. IRC sec. 2704(c)(2).

A nettlesome tax feature of grantor retained trusts is they typically do not accomplish their purposes if the donor dies during the term of the trust. In that case, the corpus of the trust is pulled back into the estate as a "retained life estate,"[75] and credit is given for any gift tax that had been paid on the remainder interest when the trust was created. This is not a disastrous consequence, but it does mean that a good deal of planning and trust administration will have produced no tax benefit. To minimize this risk, some planners set up the trusts with relatively short terms (three years or so seems common), and use relatively high annuity payouts to reduce the value of the remainder interest (and thus reduce the size of the current gift). If the assets in the trust appreciate quickly, these trusts can remove considerable value from the estate at a modest gift tax cost. They may be especially useful, then, for an individual who thinks that his company may make an initial public offering of its stock within the trust's term, or the like.

Although all of the permissible forms of retained interest trusts are used to some degree, especially among the very wealthiest families, one of the most common uses appears to be the QPRT, especially for vacation or other non-primary homes. Real estate is thought reliably to appreciate, so the advantages of fixing a relatively low current value at the creation of the trust seem especially appealing in those cases.

7. Other Devices – A number of other devices appear to be used somewhat less frequently, and so will be described somewhat cursorily in this section. The first device is the "Intentionally Defective Grantor Trust," or "IDGT." In some cases, creators of trusts seek to avoid grantor trust status, since the income of such trusts continues to be taxable to the grantor. In the case of an IDGT,

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[75] IRC sec. 2036.

the grantor trust prohibitions are intentionally breached, so that the grantor continues to diminish her own estate by the amount of the income tax obligations accruing to the trust, and so that the trust can undertake transactions with the donor that would be income-tax recognition events were it not for the grantor trust rules. Frequently, these trusts are used to purchase property from the grantor of the trust, the advantage being that the grantor trust rules make the purchase and sale a nontaxable event, since they are viewed for tax purposes as being bought and sold by the same person. IDGTs are, however, subject at the moment to some legal uncertainties, and some practitioners do not appear to regard the advantages as worth the risks and complexities.[76]

Some practitioners recommend the use of Private Annuities, by which title to a valuable asset is transferred, typically to a relative who might otherwise have received the property by bequest, in exchange for a promise to pay annuity benefits for the remainder of the transferor's life. The idea is that the property will be removed from the estate, but without any gift tax consequences. However, if the annuity is properly valued, and the grantor lives to a normal life expectancy, the annuity benefits will roughly replace the value transferred out of the estate, leaving little net benefit. And if the annuity benefits are less than the expected value transferred, there should be a taxable gift in the amount of the difference. In some cases, however, there may be some tax advantages to transferring out of the estate property that is expected to appreciate, in exchange for a stream of payments that will equal the property's present value, but would be less than the expected value of

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[76] For a description of some of these uncertainties, albeit in a context of some approbation nevertheless, see S. Schlesinger and D. Mark, "Selected Sophisticated Estate Planning Techniques," in Valuation, Taxation, and Planning Techniques for Sophisticated Estates, at 733, 742-44 (Practising Law Institute, 2000). This was a point of some divergence among the group of interviewees for this paper, with some believing that any risks could be adequately contained, and that the IDGT could be a very useful device.

the property at the time of the transferor's death.

Asset Protection Trusts, under which assets are transferred to a trust in a jurisdiction which has adopted rules that make it more difficult for creditors of the grantor to reach assets held in such trusts,[77] are by all accounts increasingly popular, though the estate planners who were the sources of background information for this paper reported very little interest on the part of their clients in such trusts. By itself, such a trust accomplishes little estate tax avoidance, though it may be that one of the other trust vehicles discussed herein would be used in combination with the sort of creditor protection opportunities now available. It is thought by the Treasury that many of these trusts, at least when they are created in foreign jurisdictions that do not freely share tax information with the U.S., are devices not of avoidance, but of evasion, of both income and transfer taxes. Because of the possibly illicit motivations behind such trusts, it is obviously difficult to develop any significant information on the extent of such activity.

An avoidance device that is intended to allow wealthy families to avoid transfer taxes after the first death is the so-called "Dynasty Trust." These trusts are intended to be perpetual, and so are set up in one of the jurisdictions that has repealed any sort of rule against perpetuities. They create vehicles that the GST tax was intended to reach, but, because their initial capitalization is set at (or below) the $1,030,000 GST tax exemption level, they slip under the reach of that tax. Some estate planners reported that their clients are not sufficiently interested in benefitting remote heirs to bother with creating such trusts. Others, however, said that very wealthy families often find these quite

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[77] The Cayman Islands have been a popular destination for such trust funds; however, in recent years Delaware and Alaska, among other U.S. jurisdictions, have begun competing for these funds by adopting trust law provisions that apparently provide similar insulation from creditors.

attractive, especially when structured in trusts that give the trustees broad powers to distribute benefits only to the needy members of the grantor's descendants, such as those with disabilities.

One final option to be considered is the possibility that wealthy testators might avoid the gift and estate taxes by greater consumption. This option does not require the wise counsel of tax advisors, and perhaps for that reason was not mentioned by the panel of estate planners consulted in preparation of this paper. But it may be worth mentioning, if only because the possibility is thought to present one of the major moral hazards associated with the estate and gift taxes.[78] One obstacle to reducing transfer taxes through greater consumption for the very wealthy, of course, is that they can hardly spend their wealth quickly enough to prevent it from further accumulating. An individual who owns $1 billion of assets, conservatively invested, say, in tax-exempt bonds paying a 5% annual return, would be saddled with about $137,000 of (tax-free) income to dispose of each day of the year. Such individuals may find that even their attempts at consumption involve incidental investment qualities that result in further, unintended, accumulation. They may, for example, strenuously consume the fair rental value of that charming apartment in the Fifth Arrondisement, or a nicely outfitted yacht, year after year, only to find that these assets keep appreciating anyway, enriching their heirs against their will, as it were. It has been noted that the very wealthy do indeed save a great deal–more than can be explained by the usual life-cycle explanations of savings.[79] But at the same time there is some evidence that wealth accumulation is

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[78] See, e.g., Edward McCaffrey, "The Uneasy Case for Wealth Transfer Taxation," 104 Yale L.J. 283, 318-324 (1994).

[79] See Christopher Carroll, "Why Do the Rich Save So Much?," in Does Atlas Shrug? The Economic Consequences of Taxing the Rich, (Slemrod, ed., 2000) at 366. This article focuses in large part on the possibility that having great wealth is itself a major source of utility, and so continues to be pursued even by those who already have achieved such great wealth that

adversely impacted by transfer taxes,[80] suggesting at least a possible role for consumption. Suffice it to say at this point that one encounters very little anecdotal evidence suggesting that the very wealthy embark on spending sprees as a means of reducing their estates; at the same time, it cannot be denied that transfer taxes, by taxing wealth transfers, clearly provide incentives for additional consumption, compared to a tax system in which all consumption taxes remained in place, but from which wealth transfer taxes had been removed.

8. Post-Mortem Estate Planning and Valuation Issues – Although "post-mortem estate planning" seems a contradiction in terms,[81] there are in fact a number of things that an executor can do to reduce the tax burdens of their deceased clients. One major area of attention is assuring that the marital deduction has been appropriately balanced to minimize total transfer taxes on the two estates that a husband and wife will leave. For example, if circumstances make it desirable, the executor can elect not to include certain property that would qualify for the marital deduction in the schedule of property for which a marital deduction is claimed. Similarly, in some cases heirs may wish to disclaim gifts, which can generally be done without incurring transfer tax liabilities. Again, counseling by the executor or legal advisor to the estate about the consequences of such disclaimers can frequently achieve a better result than would obtain without explicit consideration of this option.

Probably the most important role in this area is not usually considered "planning" per se, but

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the buying power afforded by that wealth would seem at the margin to have lost its meaning.

[80] See William Gale, "Do Estate Taxes Reduce Saving?," Univ. of Michigan Office of Tax Policy Research Working Paper No. xxx. (2000).

[81] Estate planners seem to have a taste for this sort of thing, since they also refer sometimes to "pre-mortem probate" issues.

rather simply intelligent completion of the estate tax return. One of the executor's duties is to value the assets of the decedent, an area in which a good deal of judgment is often involved. Unsurprisingly, that judgment is usually exercised in a way that resolves all doubts in favor of lower values.[82]

Several valuation-discount doctrines have emerged from cases in which estates have successfully argued for lower values than the IRS believed appropriate. One of the major discount situations is presented when the estate has a large quantity of a particular kind of property, most typically, the stock of a corporation. In such cases, a "blockage" discount may be claimed on grounds that disposition of a large number of shares within a short span of time would inevitably push down the price; the demand over any period, it is argued, is relatively fixed, so sudden expansions of the supply of tradable stock must have a negative effect on fair market value. This theory is applied to provide modest discounts from the trading price on the valuation date of five percent or so even on publicly traded stock.[83] With respect to the stock of corporations that is not publicly traded, there is of course no clear benchmark from which the discount can even be measured. But, as an illustration, in one Tax Court case last year, the court found a block of stock to be worth only $276 per share, even though the estate itself had sold some of the stock not long after the valuation date for a price of $355 per share.[84]

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[82] This is of course only true as to taxable estates; in ones that are below the threshold of taxability, incentives exist to shade the valuations on high side, if anything, because the reported valuation also sets the tax basis under IRC sec. 1014 for the heirs who receive the property.

[83] See, e.g., Foote v. Comm'r, 77 T.C.M. 1356 (1999) (3.3% discount); Gillespie v. U.S. 23 F.3d 36 (2d Cir., 1994) (4.85% discount).

[84] Branson v. Comm'r, 78 T.C.M. 78 (1999). The block of stock sold represented a bit less than 10% of the total shares held by the estate. The discount allowed from this sale price

Discounts have also been allowed with respect to real estate,[85] and even works of art. In the case of Georgia O'Keefe's estate, for example, the estate consisted primarily of some 425 works of art that had been appraised at over $72 million. The court divided the works into two equally valuable groups: those that could be sold within a reasonably short period of time, and those that might have required more deliberate marketing; it then applied a 25% discount to the former, and a 75% discount to the later, reaching an ultimate valuation for the estate of about $36 million.[86]

The theory behind these discounts is troubling, at least insofar as it seems to lead to liquidation or "fire-sale" valuations. In fact, the estate is typically under no compulsion to liquidate the assets; except for the payment of the estate tax itself,[87] there is no need generally for the estate to liquidate the assets at all, much less to do so quickly. Rather, the assets can and usually are passed on in kind to the heirs. The regulations do call for a fair market valuation as of a particular date, and courts have over time come to view that as meaning the value that could be produced by an immediate sale. But the effect of this seems to be to undervalue substantially the assets in large estates, precisely because they are either very large overall or particularly concentrated in one asset.

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was about 22%. The estate had initially claimed a discount of nearly fifty percent, computed on the basis of the actual sale price.

[85] See, e.g., Auker v. Comm'r, 75 T.C.M. 2321 (1998). This case allowed a 6% discount from the appraised value of three apartment complexes that were in the estate, to allow for market absorption of the buildings. The estate had sought a 15% discount.

[86] O'Keefe v. Comm'r, 63 T.C.M. 2699 (1992). Remarkably, the estate initially appealed this outcome, but the appeal was later withdrawn.

[87] The estate tax return is due nine months after death, and payment of the tax is ordinarily made with the return. If the estate consists largely of closely held business interests, however, payment of the tax can be deferred for five years, and paid in installments over the following ten years. See IRC sec. 6166.

Discounts are also routinely sought and allowed, in varying amounts, in a variety of other situations, involving such things as restrictions on transferability of the shares; the fact that the shares held by the estate represent a minority interest in the corporation; the possibility that the shares may be worth less precisely because of the death of the testator, who may have been a key executive of the company; and so on.

9. Effectiveness of Avoidance Measures – How effective overall are the avoidance devices described? Clearly, many of the examples provided in the foregoing, some of which are drawn from actual decided cases, indicate that discounts of fifty percent or more are not beyond the range of possibility. Indeed, in smaller estates, good planning could certainly reduce a potentially taxable estate to one that would be below the threshold for taxability. Mrs. Church's estate provides a concrete example.[88] A more representative, albeit hypothetical, case might involve a couple in their sixties, in which one spouse holds $3,000,000 of wealth, while the other owns only trivial assets. The potential estate of the spouse holding the wealth would be right on the edge of the top estate tax marginal rate bracket of 55%, and would face a potential estate tax liability of $1,070.250.[89] But suppose that the couple: 1) spends any income and appreciation in value of the estate over their remaining, retirement years; 2) gives gifts to each of two children and four grandchildren of $20,000 per year for ten years, depleting their estates by $1,200,000; 3) achieves, through a family partnership

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[88] Note 62, supra.

[89] This is a slight overstatement, since the estate would almost certainly have some deductions, if only for probate fees, and likely some credits for state death taxes as well. Still, it would be quite possible to reach a total transfer tax liability of $1,000,000, if the spouse with the assets is the second to die, and undertakes no steps to reduce exposure to the those taxes.

or otherwise, a 30% discount in value of the remaining $1,800,000 of assets, thus producing an estate valuation of $1,260,000; and, 4) uses any of several mechanisms to divide the potential estate of the wealthy spouse more or less evenly between the two. They, or rather their heirs, will then find that no federal transfer taxes will have been paid during the couple's lives, nor owed at death, on the transfer of the total of $3,000,000 to the next generation.

Larger estates are likely to find it more difficult to avoid transfer taxes altogether. However, the experienced estate planners interviewed for this article believed that discounts of about one-third of the value of even very large estates could be achieved through good planning, perhaps a bit more or less depending on the circumstances of the testator, including such things as his or her age, marital status, the number of intended beneficiaries (which affects the ability to use annual gift tax exclusions effectively), and the nature of the assets in the estate. This is an extremely rough and unscientific guess at the percentage that escapes from the estate tax. In addition to data collection problems, estimating this percentage involves at least one troubling conceptual question as well: if A transfers $X of value to her child early in life, and the value of the property comes to be, say, $4X by the time of A's death, is the amount of wealth transferred to the next generation equal to $X, or $4X, or perhaps at some intermediate figure that represents the value as of the first date that the child had unfettered access to the assets? If one wishes to exaggerate transfer-tax avoidance, date of death valuations would be chosen. Most unbiased observers would probably chose the intermediate value, at the point where the child actually gains control of the value. But certainly a reasonable argument can be made that, once the parent has irrevocably transferred value out of her own portfolio, any subsequent gains cannot be said to be wealth that she has transferred, but rather are earnings that at all times belonged to the child. No guidance on this question was given to the interviewees who estimated that at least one-third of all wealth transferred from planned estates escapes taxation. So, together with data questions, it must be conceded that doubts about this major issue in transfer tax cannot be put aside.

Nevertheless, assuming for the moment that their best guess is about right, and that one-third or a bit more of the potential base of the transfer taxes eludes the reach of that tax, what should be made of that? On the one hand, it represents a sizable leakage from the potential tax base. But on the other, it certainly falls far short of confirming the popular belief that the very wealthy can completely avoid transfer taxes through clever planning.

In fact, it appears that the popular view exaggerates the ease of wholesale avoidance of the transfer taxes, for several distinct reasons. First, this view tends to ignore the fact that many of the avoidance devices require earlier disposition of assets than most testators feel comfortable with, or, alternatively, they require asset transfers–from outright, direct ownership into an indirect ownership form, such as through a partnership--that testators regard as inconvenient. Many avoidance devices, in many circumstances, carry private costs that exceed their value in terms of transfer-tax reduction.

Second, many devices–especially those that are designed to "freeze" the value of an estate at something approximating its level at some particular starting point--benefit from what might be called a hindsight fallacy. Because both corporate stock and real estate investments have, as a whole, performed spectacularly well over the last decade, devices that positioned the moment of transfer taxability at some date in the early 1990s now appear to have been very wise. The property, or more typically some kind of remainder interest in property, was transferred for tax purposes when the value was relatively low, and now, years later, the actual transfer of the remainder interest occurs when the value is much higher. In a period of relatively stable or falling asset valuations, however, many avoidance devices offer little prospect of lowering transfer taxes; at most, they lower somewhat the absolute amount of the transfer tax, but accelerate the incidence of the tax, so that the present value of the tax paid is about as much or more than it would have been absent any special planning. A simple example will illustrate this point: If a donor were to put $1000 into a trust at the beginning of year 1, with a qualified remainder interest in the trust going to a beneficiary after ten years, any gift tax liability would be based on the discounted present value of a ten-year deferred gift, as of year one. At an 8% discount rate, the remainder interest in those assets would be valued at about $463, and the transfer tax based on that sum would be no more than 60% of that, or $278. If the assets in the trust rise over the decade to, say, $5000, this will have been a good deal: $5000 of assets will have been transferred at a cost of only $278 of tax. However, if the value of the assets instead remains in the vicinity of $1000, no real tax avoidance will have been accomplished. At an 8% discount rate, $278 at the beginning of a ten-year period has precisely the same present value as $600 does at the end of that period.[90] And if the value falls, the donor will in effect have suffered a transfer-tax penalty.

A third source of exaggeration of the potency of avoidance measures is related to the second. It stems from a more general tendency to ignore time-value considerations in assessing tax avoidance. If a wealthy person has $X of wealth at some point in time, and devices can be created to transfer the same amount to the heirs some years later, without explicit payment of a wealth transfer tax, it may be thought by some that no transfer tax burdens have been absorbed, even though the income from the assets during the period in question is unavailable to anyone in the family.

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[90] An eight percent rate, compounded over ten years, yields a multiplier of 2.159, which, when multiplied times the $278 of tax, equals $600. $600, of course, is the maximum transfer tax that would be paid on the transfer of $1000.

Charitable lead trusts have this quality, and are featured prominently in many discussions of avoidance. For example, George Cooper, in his book on sophisticated estate planning, offered a hypothetical plan by which the then current generation of the duPont family might avoid transfer taxes completely.[91] But one of the major devices required transfer of about half of the family's assets into a charitable lead trust of 24 years duration. At the time Cooper was writing, interest rates were in the double-digit range; at those rates, the value of a 24-year income interest in a fund would constitute more than 90% of the total value of the fund. Because that fund constituted about half of their potential estates, Cooper would have the duPonts avoiding transfer taxes by giving away about 45% of the value of their property to charity. Of course, transfer taxes should be completely avoidable only if <u>all</u> the property is given to charity, so Cooper's strategies–which also involved some shuffling of assets to generate a plausible basis for claiming substantial discounts–certainly would have accomplished a considerable reduction in the transfer-tax burdens borne by the family. But to say that the family would be completely free of transfer tax burdens ignores the very substantial cost of losing a 24-year income stream from a large portion of the family assets.

Some popular accounts of the transfer tax avoidance dynamic contain elements of all three of these sources of exaggeration. Consideration of one such example in some detail may be useful: A famous <u>New York Times</u> article of a few years ago begins with the story of a New Jersey tax lawyer, who, at age 40, reportedly transferred title to the family residence (which he owned outright, without any mortgage) to his three children, the oldest of whom was then 11, in exchange for the

[91] George Cooper, <u>A Voluntary Tax?: New Perspectives on Sophisticated Estate Tax Avoidance</u>, (Brookings, 1979). The book was an expanded and updated version of an article that Cooper published in 1977 in the Columbia Law Review.

right to live in the house rent-free for the next 25 years.[92] The house was then worth $539,000, but the donor projected that the value of the house would rise by about 4% per year, and would, by the end of the 25-year period, be worth about $1.4 million. Despite the fact that that value would then pass to the children, the valuation of the gift for tax purposes was only about $84,000–the then current value of the house, less the $455,000 value assigned to the right retained by the donro to continue living in the house for 25 years. And, because the donor had not used up his unified credit, no immediate gift tax was owed, even though the gift was not one of a present interest.[93]

This is a clever idea. But it accomplishes somewhat less tax avoidance than might at first be supposed. To begin with, although the assumption that the house will appreciate by 4% per year sounds conservative at first blush, it isn't quite so conservative if one accounts for the fact that the house is also producing a return in the form of its rental value, which should be around $4000 per month, or something in the range of an 8% (or higher) rate of return. The 4% appreciation assumption, stacked on top of that, means that the donor expects at least a 12% return on the capital invested in this house. That may happen to some houses, in some neighborhoods, at some times, but developing a model based on an assumption of a 12% compound return over 25 years is, as a general matter, rather speculative. It is, in a sense, the inverse of the hindsight fallacy: instead of looking backward, and deciding that a tax-avoidance strategy was good, when all that happened was that the

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[92] Christopher Drew and David Cay Johnston, "Rushing Away from Taxes: Preserving the Legacy–A Special Report," New York Times, December 22, 1996, at A1. Though the article describes the transaction as though it were a direct gift of a remainder interest to the children, it was presumably a transfer instead to a qualified personal residence trust, of the sort described in section B. 6, supra, since the latter type of transfer would have produced much better tax results.

[93] As explained in section A.2. supra, the effect of this will be to make $84,000 more of Shenkman's estate taxable at death, because of the partial exhaustion of the lifetime unified credit.

market was good, this strategy looks forward, and assumes an exceptionally good market performance into the future.

But suppose the good-market assumption is borne out by subsequent events. Will this turn out to be a good idea? Perhaps so, but mostly because this arrangement will benefit from a form of leverage. Instead of getting a net return of 4% on an investment of $84,000, the 4% return compounds on an investment of $539,000, the full value of the house. The cleverness of the idea is in using the offsetting obligation (to provide housing to the donor's family rent-free) to reduce the size of the current net transfer, and hence the transfer tax. It is rather as if the donor had given his children $84,000 for a down payment on the house, and loaned them the remaining $455,000 of the amount needed to buy the house, with their "virtual mortgage" being paid back in the form of the 25-year rental value of the house.

In fact, it might have been better if the donor had done that somewhat simpler transaction; that is, if he had simply given the children enough for a down payment on some house other than the family residence. If the rent received in the market covered the mortgage payment, property tax, insurance, and maintenance, they would still be in a position to enjoy the leveraged benefits of the appreciation on the full value of the house, even though their investment only represented a small slice of it. Or simply putting $84,000 into a NASDAQ index fund, leveraged with as much margin as they could manage, would also have done very well. Why might those have been preferable? Because there are some major inconveniences to using a family's own residence to fuel this device. If the donor decides that he wants to move within the 25-year period, he will need to undertake some fairly complicated corrective actions to comply with the terms of the agreement. And what about improvements to the house? What if the donor decides in 2010 to do a major kitchen remodeling?

This sort of periodic infusion of home improvement capital is the sort of thing that is usually necessary to offset the natural depreciation of buildings over time (and to maintain any hope of achieving that 4% annual appreciation). But in this case, it seems likely that each such capital infusion would also constitute a new gift at that time to the children.[94] Finally, when the property is ultimately transferred to the children, it is likely that they would not be eligible for the forgiveness of up to $500,000 of capital gain that is now available to homeowners on the sale of their personal residences, since they would presumably no longer reside in the house by the time their remainder interest ripens.[95]

In summary, it seems that what magic there may appear to be in this arrangement depends mostly on making a heavily leveraged investment in a (presumably) rising market, for a 25-year period. That scenario will always produce happy results, as long as subsequent events bear out the assumptions. And the remaining magic inheres in the idea of making transfers to children earlier in life rather than later, so that the asset appreciation never shows up in the parents' own base of wealth to be transferred. But that's an easy move; the personal residence strategy doesn't really improve

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[94] Of course, the IRS is nowhere near vigilant enough to pick up on this sort of thing as a routine matter; indeed, gifts in kind are thought to be routinely unreported, even when they exceed the annual exclusion or are not present interests. [See David Cay Johnston, supra, note 63] Still, the possibility that subsequent, potentially taxable gifts might be involved in this device is the sort of thing that should give a tax lawyer some pause, especially if this "product" is being to be marketed to clients as part of an overall tax avoidance strategy.

[95] This provision is contained in the 1997 amendments to IRC sec. 121, which was enacted after the trust in this case was created. This illustrates, among other things, one of the perils of clever tax planning on a 25-year time horizon: Congress changes the tax laws each legislative session, and the strategy that appears best at one point may not be as attractive in subsequent years, under new rules.

on that move very much, except insofar as it provides a convenient means of leveraging the gift.[96]

One is reminded a little of the days before the Tax Reform Act of 1986, when it was nearly impossible to attend a cocktail party or barbecue without hearing some discussion of the latest income tax shelter.[97] Even the devices that probably worked were never as attractive overall as they seemed to be when described by the promoters, or their true believers, and many had serious tax or economic shortcomings that only became apparent when the details of the plan were carefully examined.

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[96]The other items mentioned in the New York Times article mostly consist of devices described elsewhere in this article, such as the use of family partnerships and insurance trusts. They also mention the use of transferred stock options, which is again an opportunity to transfer a leveraged investment to a younger generation, which will seem very attractive as long as the investment does well. Also mentioned is the dubious technique of having a surviving spouse buy the children's right to inherit, as a means of stripping the parent's estate; but it is not clear, even from the favorable description in the article, that this technique works from either a legal or an economic point of view. The parties in the actual case on which this was based paid substantial taxes in the first instance, and settled the estate tax question with the IRS for an undisclosed additional sum–hardly a result that seems likely to spawn legions of imitators. Finally, the article mentions enforcement difficulties that can result when a decedent held assets in secret foreign bank accounts. These may be significant, but the problem in this area is largely one of evasion of tax, about which reliable information is inherently difficult to find. The estate planners consulted for this article reported, naturally, that they would never encourage or cooperate in any scheme of tax evasion. Somewhat more surprising, they reported that their clients themselves showed little interest in such options. It does seem likely that very wealthy persons would be quite risk averse as to criminal sanctions: if one has great wealth already, one would think that illegal means of preserving more of that wealth for their heirs would not be worth even a remote chance of a stay in Leavenworth. While it must be conceded that the sample of estate planners drawn for the preparation of this paper was neither a random nor a cross-sectional slice of the profession, but rather distinctly tilted toward the upper end, it should also be noted that most high-wealth individuals seek out precisely the sort of practitioner who was interviewed for this paper.

[97] Possibly, this was only true if one happened to be a tax lawyer, as one does indeed happen to be. But tax shelters appeared to be of quite general interest among upper-middle and upper bracket taxpayers at the time.

The Costs of Transfer Tax Avoidance

There are several different sorts of costs associated with transfer-tax avoidance. Some of the strategies affect the actions of testators, and in that sense distort those actions from what they would presumably be in a system that imposed no transfer taxes. There are also direct costs of effecting the transfer-tax-avoidance strategies, consisting of fees paid to lawyers, accountants, trustees, and appraisers. And there are public costs associated with the need to police the tax-avoidance efforts, and assure that the law is reasonably enforced. Each of these will be considered separately below.

1. Distortion -- Much of the cost of transfer-tax avoidance results from engaging in tax-favored dispositive arrangements that are, from a nontax viewpoint, less desirable than one or more of the alternatives available. Thus, wealthy individuals may leave more (or less) to a spouse than they would in the absence of transfer-tax considerations. Wealthy individuals may make significant transfers of wealth during their lives because of the tax features associated with some such transfers, when their preferences otherwise would be to retain all (or in any event more) of their property until death. Testators may make charitable gifts that they would not make, or in forms that would not be used, but for transfer-tax considerations. The distortion of choice implicit in these devices often becomes too great, which substantially explains why testators generally do not adopt the most aggressive estate plans imaginable under their particular circumstances, and why many will always "volunteer" to pay more transfer tax than some hypothetical minimum.

Those who do adopt tax avoidance strategies surely suffer welfare losses of some magnitude as a result of distorted choices. However, in most cases, the distortions involve making transfers earlier than the testators desire, or to a different beneficiary.[98] Under these circumstances, there would be little or no systematic effect on resource allocation, and hence little or no welfare loss overall. Consumption opportunities are simply transferred to spouses or to subsequent generations differently then they might have been, but in ways that merely shuffle utility rather than destroying it.[99]

In addition to affecting the timing of transfers and the choice of individual beneficiaries, transfer-tax avoidance no doubt motivates some charitable gifts. But the analysis just described seems equally applicable in the charitable context: the utility of the individual testator is reduced, compared to a tax-free state in which the charitable gift would not have been made, but in a way that presumptively preserves aggregate utility, which is simply transferred to the indirect beneficiaries of the charitable enterprise supported by the gift in question.

There are some exceptions, however, to the general notion that transfers among natural persons, and from natural persons to charitable entities, preserve welfare. In particular, it seems likely that wealthy Americans buy more life insurance than they otherwise might because of transfer

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[98] The status of the beneficiary has salience primarily in the marital context. As explained in section B.2 above, there are circumstances in which the tax-wise disposition will require a larger transfer to a spouse, and other circumstances in which it will require a smaller transfer. In either case, the transferor will lose utility if she makes a tax-induced second-best transfer.

[99] The archetypal tax-avoidance-induced transfer is from an elderly person of wealth, who will likely hold the assets until death if he doesn't give them away earlier, to a person in youth or middle age, who is much likelier to spend them. It might seem that the younger person would get more utility from using the resources than the elderly person gets from merely holding them, but such a judgment involves the sort of interpersonal utility comparison that most economists find extremely problematic. The archetypal transfer may also have implications for savings rates: if very wealthy elderly people save more than less wealthy younger people, and if transfer taxes induce earlier wealth transfers from older people to younger ones, then the overall savings rate will decline. Again, however, there is no clear welfare loss in this; the new savings rate is presumably the optimal one for whatever the new wealth distribution is.

tax avoidance efforts. Estimating the welfare loss created by this distortion is beyond the scope of this paper, and the abilities of its author. But a few points that tend to mitigate this distortion should be noted. First, many testators seek insurance to provide estate liquidity for reasons that have more to do with orderly conduct of an on-going business that they do with wealth transfer taxes. For example, if two unrelated individuals conduct a partnership business together, they are likely to seek some sort of buy-sell arrangement, under which the estate of the first to die must sell the estate's share of the business to the survivor. Insurance would often be used to provide the resources to effect such a purchase and sale, and would be desirable in such cases without regard to any wealth transfer tax considerations.

Second, insurance has a substantial financial value that is independent of the motive for its purchase. Even if an individual would not have purchased a particular policy but for tax-avoidance motives, it does not follow that the premiums paid for that insurance are a net loss to the individual (much less to society overall). Even in the case of term insurance, in which investment values are intentionally minimized, the value of the pure life expectancy gamble–roughly, the death benefit times the probability of death within the period covered by the premium–remains an asset of the testator. So the social cost of this distortion seems quite limited, and could be thought of casually as the cost of having a somewhat larger than optimal number of people employed in sales, clerical, and actuarial functions in the insurance industry, rather than in similar functions elsewhere in the broader financial services sector.

Distortion possibilities may also inhere in the rearrangement of assets that is sometimes undertaken to lower valuations. Testators certainly claim that the market value of such things as interests in family limited partnerships is well below the net asset valuation of the property owned by the partnership, which suggests, as noted above, that testators have to some degree vandalized their property in their frantic search for transfer-tax avoidance. However, on closer analysis, it appears that what testators typically do in these cases is to lower the marketability of the property, making investments less attractive to outsiders, hopefully without doing serious damage to the income-producing power of the property itself. There is a loss of liquidity in that process, and that is surely a genuine welfare loss; but its magnitude would be of a much lower order than the amount of the discounts sought by testators engaging in valuation-lowering strategies of this sort. In fact, even while they are arguing the case for discounting the value of partnership interests, testators (or their representatives) typically argue that the partnerships were set up to advance the interests of the businesses and investments contained within the partnership vehicle, by consolidating management of disparate bits of an enterprise, for example.[100] If there is truth to that claim, then there would be in those cases no loss from transfers of property into partnership solution.[101]

2. Direct Costs – The direct costs of estate planning consist of the fees of the professionals–typically lawyers and accountants-- who put together the plan, trustees who administer

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[100] Such an argument anticipates an IRS argument that the partnership can be disregarded as a mere device to reduce taxes, with no other purpose. See discussion above in section B.5. The IRS has raised this argument in cases such as Estate of Schauerhamer v. Comm'r, 73 TCM 2855 (1997), but has not achieved definitive resolution of whether some sort of business purpose need be shown to sustain recognition of the limited partnership as the true holder for tax purposes of the assets to which it had legal title.

[101] It should not be argued that such asset transfers represent a positive welfare change, however, since the argument noted in the text is that these moves are made for nontax business reasons, to achieve the most efficient deployment of assets. In this view, if these moves happen, somewhat paradoxically, to lower transfer tax valuations, then that is merely a happy by-product of a transaction that would have taken place anyway; to attribute any efficiency improvements to the transfer tax rules would thus contradict the basic premise of the argument.

funds transferred into trust, and in some cases the appraisers who help wealthy individuals set the values claimed on gift and estate tax returns. Although these fees may seem large in some absolute sense, they are typically quite modest as a percentage of the transfer tax saved, and almost negligible as a percentage of the assets transferred. About half of the estate planners consulted in the preparation of this paper reported that they had rather standard packages that they would make available to individuals who would leave estates in the $3 to 10 million range that might be provided for as little as $3000 to $5000. Larger estates, or any estate requiring substantial variations from the standard plans, would typically pay the planner an hourly fee that is likely to be in the range of $250 to $550, depending on the experience of the planner, the cost factors of the relevant legal market, and the like.[102] But even quite wealthy individuals, who might save millions of dollars of transfer tax by a sound estate plan (compared to the tax that might be imposed by a transfer at death pursuant to a state's laws of intestate succession), might pay an estate planner less than $20,000 for their plans. If a plan involves difficult valuation issues, appraisal fees are likely to be involved, and may be significant.

The estate planners interviewed for this paper were also asked to estimate what percentage of their work was not directly related to the transfer tax rules, but rather to the need simply to transfer substantial assets to beneficiaries in an orderly way. Specifically, they were asked to engage in the

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[102] This was the range of fees among estate planners consulted for this article, all of whom were practicing for large, urban law firms. In many cases, estate planning services are offered by lawyers in smaller towns, accountants, and financial planners, many of whom would presumably charge lower fees. It thus seems likely that the overall average rate for estate planning services is toward the lower end of the range mentioned in the text.

thought experiment of imagining that the transfer tax system had been repealed.[103] Putting aside transitional effects, and looking forward to a steady-state situation in which repeal was believed to be permanent, those planners who were willing to guess on this point generally thought that about half of the current level of services would continue to be required.[104]

Thus, while the interviews on which this paper was prepared do not provide a firm basis for empirical findings on the aggregate cost of estate planning, they do permit a rough guess. If there are about 5,000,000 American families (about five percent of the total) who have sufficient wealth that they should be at least a little concerned about wealth transfer taxes,[105] and if those families engage in a thorough review of their estate plans every ten years, on average, at an average cost of $5000 per review, and if 50% of the cost of that review is attributable to tax minimization concerns, then the planning costs attributable to transfer tax considerations would amount to about $1.25 billion per year.

Others who have analyzed estate planning costs have come to widely varying conclusions.

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[103] One estate planner noted astutely that for at least the five years following repeal, estate planners would enjoy great demand for their services, because their clients would not regard the repeal as permanent, and would be scrambling to take advantage of a window of opportunity to get assets out of their estates free of transfer tax, while at the same time striving to retain as much control over the use of those assets as possible. Even if the repeal were taken as permanent, there would be a considerable one-time need for review of estate plans for provisions that involved some compromise between tax considerations and dispositive preferences, which could then be amended to more perfectly effect the latter.

[104] Even this number may turn out to be pessimistic, from the estate planners viewpoint. See Jonathan Clements, "Estate Planning Outlives 'Death' Tax," Wall St. Jour., July 25, 2000, p. C1, which suggests that the bulk of estate planning currently undertaken would still be required even in a post-transfer-tax situation.

[105] In 1995, only about 3.4% of all deaths resulted in the filing of an estate tax return, suggesting that the five percent parameter is roughly reasonable. Johnson and Mikow, supra, note 11, at 71.

Aaron and Munnell offered an informed guess that overall transfer tax compliance costs were "a sizable fraction" of the total revenue generated by the tax, which at the time was about $6 billion.[106] However, it seems likely that in the years since their article, revenue has grown much more quickly than estate planning costs. Revenue has increased nearly five-fold; comparably precise estimates of compliance costs are not available, but there have been no reports of the sort of widespread increase in either individual fees nor the number of professionals engaged in estate planning that would support a guess that those costs had increased by anything like the same proportion.

In their excellent and comprehensive survey of current transfer tax issues, Davenport and Soled estimated the aggregate costs of estate planning, and reviewed a number of estimates made by others.[107] Their estimates for both the costs of estate planning, and of administering the estates were based on their own interviews with estate planners, and on analysis of costs reported on estate tax returns. They estimated planning costs for 1999 at a bit in excess of $1.047 billion, and administration costs at $856 gross, with a net cost to the estates (because administration costs are deductible against the estate tax) of $471 million.[108]

Astrachan and Tutterow analyzed the results of polling data conducted among small business

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[106] Henry J. Aaron and Alicia H. Munnell, "Reassessing the Role for Wealth Transfer Taxes," 45 Nat'l Tax Journal 119, 138 (1992). They did not indicate what a "sizable fraction" might be, but they did conclude that high avoidance costs suggested that the "ratio of excess burden to revenue of wealth transfer taxes is among the highest of all taxes," which they appeared to find deeply problematic. Id., at 139.

[107] Charles Davenport and Jay A. Soled, "Enlivening the Death-Tax Death-Talk," 84 Tax Notes 591, 619-25 (1999).

[108] Id., at 621 and 622, respectively.

owners, which produced much higher estimates of estate planning costs.[109] Their pool of over 1000 owners of "family businesses" reported spending an average of $33,137 for estate planning services from lawyers, accountants, and financial planners.[110] There is some basis for skepticism about the results of this survey, for a few reasons. First, the questions about the cost of estate planning come in the context of an overall survey that surely invited hostility to transfer taxes.[111] And some of the results seem at least mildly internally inconsisent.[112] It should also be noted that the consumers of financial and estate planning services may not be in a position to know in any detail what part of the professional time for which they were billed might have been necessary for non-tax reasons. Mostly, however, the results of the survey simply strain credulity, in the light of what is known about what estate planners can and do produce for their clients: a handful of relatively simple documents, most of which have been only lightly customized for the particular client. At billing rates of $300 per

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[109] Joseph Astrachan and Roger Tutterow, "The Effects of Estate Taxes on Family Business: Survey Results," IX Family Business Review 309 (1996).

[110] Id., at 306. Family businesses in the pool had revenues of at least $1,000,000 annually, and had at least two officers or directors with the same last name.

[111] The survey invited respondents to report on how the estate tax limited business growth, threatened survival of the business, affected investment horizons, affected employment decisions, and other similar questions. (Of course, it must be admitted that the estate planners who were the primary sources for this paper, and for Davenport and Soled's, are not disinterested either, and may have bias in the opposite direction from that observed among family business owners.)

[112] For example, the survey indicated that 45% of the respondents had "no knowledge of amount of [their own] estate tax liability." But it also indicated that 60% of respondents "would immediately hire [more] workers" if the estate tax were repealed. Id., at 306. This means that at least 15% of the respondents know nothing about their potential liabilities, but are nonetheless sure that repeal would lead to expansion of their businesses. 60% of respondents also reported that their revenues would grow by 5% or more if transfer taxes were eliminated. Id. One wonders how even those who know what their transfer tax liabilities are would have any reasonable basis for believing that.

hour, which seems a reasonably generous estimate of the average billing rate for professionals in this field, $33,137 would buy over 100 hours of professional time. While this much time might not be unusual for planning the estate of an individual of great wealth, it seems well above the amount of time reasonably necessary to produce an estate plan of the sort needed by the average owner of a small to medium-sized business.[113]

3. Public Costs – The public costs of administering and policing the transfer tax system appear to be modest. In fact, they may well be too modest: it is likely that substantial additional revenue could be collected with relatively small increments to the enforcement budget, but these increments have nevertheless not been forthcoming. Davenport and Soled estimated the share of the IRS budget that could be properly attributed to transfer taxes in 1996 at $152 million.[114] Their discussion of this estimate makes clear that it is somewhat conjectural, but the estimate seems reasonable in light of the fact that the overall IRS budget is only around $8 billion, and only a small fraction of that budget is devoted to estate and gift tax questions.[115] For example, the most recently available statistics indicate that estate and gift taxes amounted to about 1.6% of federal revenues,

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[113] Two other recent works explore the costs of estate planning, but do not develop their own estimates. Daniel Miller's report for the Joint Economic Committee, "The Economics of the Estate Tax," S. Rpt. 105-89 (1999), draws on the work cited above of Astrachan and others, supra, at note 109, and on the earlier analysis of Aaron and Munell, supra at note 106. James R. Repetti's article, "The Case for the Estate and Gift Tax," 86 Tax Notes 1493, 1507 (3/13/00) relies primarily on Davenport and Soled, supra at note 107.

[114] Davenport and Soled, supra, note 107 at 619.

[115] The Budget of the United States, 2001, Table 32-2 presents an estimate for all tax administration costs, presumably including those of the Office of Tax Policy of the Treasury Department, of $8.054 billion, for the fiscal year that will end on 9/30/00.

.6% of all returns filed, and .8% of returns audited[116]. Earlier IRS reports have indicated that about 1.6% of ruling requests had estate and gift taxes as their subject.[117] Thus, the Davenport and Soled estimate, which comes to about 1.7% of the IRS budget, appears to be rather generous, toward the higher end of the range of possibilities.

If Davenport and Soled, and the views expressed in this article, which are generally consistent with their findings, are correct, then the estate and gift taxes are reasonably efficient. Under this view, the total costs of administering and complying with those taxes would appear to be around six to seven percent of the revenue generated by those taxes. This would put those taxes somewhere between the ten percent of revenue estimated by Slemrod as the administrative and compliance costs of the individual and corporate income taxes, and the three to five percent estimated by Slemrod for sales and value-added taxes.[118]

## D. Conclusions

The transfer tax system depicted in this article has two faces. On the one hand, there are a number of devices available that significantly reduce the base of the transfer tax. At the threshold of the taxable range–those estates that might be potentially in the $1-3 million range–a reasonably

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[116] The first of these numbers is derived from the 2001 Budget, Table S-11. The second is from the 1997 IRS Data Book, Table 2 (1997); and the third is from the same source, Table 11.

[117] The IRS does not appear to publish this information anymore. The number in the text is taken from the 1978 IRS Annual Report, at page 48. If anything, 1978 should have been an unrepresentatively high year for ruling requests in this area, since the major 1976 reforms were still being digested at that time.

[118] Joel Slemrod, "Which is the Simplest Tax System of Them All?," in Economic Effects of Fundamental Tax Reform 355, 368-374 (H. Aaron and W. Gale, eds., 1996).

attentive approach to the marital deduction, the annual gift tax exclusion, and the lifetime transfer-tax exclusion, can eliminate much or all of the tax liability. In the higher ranges–above about $20 million, those deductions and exclusions become relatively insignificant, but other devices, such as family partnerships and grantor-retained trusts, are available to reduce the size of the estate by at least one-third its potential size, and more in some circumstances. In the range between those two extremes, some parts of both approaches may be useful in significantly cutting transfer tax liabilities.

On the other hand, the devices have limits; the stories of complete avoidance of transfer taxes by the very wealthy are mostly hyperbolic. Massive transfers to charity or a surviving spouse can transfer wealth without wealth transfer taxes, but most other large wealth transfers will be subject to significant effective rates of tax. Further, the hypothetical strategies that could minimize the transfer tax liabilities of an individual will frequently be eschewed because of nontax considerations. In particular, the estate planners consulted in preparation of this paper consistently noted that their clients do not like paying gift taxes; yet a willingness to pay some gift tax is a virtual necessity for large estates if they wish to minimize their total transfer tax liabilities.[119] More fundamentally, as one estate planner put it: people simply don't like to give away their property while they're alive. And, as the foregoing explanations should make clear, most of the more effective strategies require a considerable willingness to make truly irrevocable transfers during the donor's life. To be sure, wealthy individuals are not all alike; some have less trouble than others in making transfers (and paying gift taxes, if necessary). And even those who find lifetime transfers and gift tax liabilities problematic usually manage to surmount their reluctance. But they do so only to a degree, and that

[119] One source said that she thought that this was related in part to the possibility of imminent repeal of transfer taxes; most sources, however, seemed to think that this reluctance was very deep-seated and long-standing.

degree falls well short of minimizing their transfer taxes.

The best proof of that is in the revenue itself: about $30.5 billion in transfer tax will be paid this year,[120] about a third of it by the thousand or so estates with more than $10 million in assets. It is virtually impossible to imagine that estates of this size did not have access to good advice, and even more unimaginable that any significant number of them "volunteered" in any meaningful sense to pay as much tax as they did.

Nor does it appear that the devices used are particularly expensive. The basic strategies are not difficult to understand. Their implementation may be somewhat more complicated than the simple descriptions in this paper have captured, but not greatly so. And while the IRS probably should spend more to enforce the transfer tax rules, it will never be in a position to spend so much that those costs will be significant as a portion of the revenue raised by these taxes.

So we have overall a highly imperfect transfer tax system, but one that is sounder at the core than it is generally assumed to be. Reform is clearly indicated, and clearly possible. A full description of the reforms needed is beyond the scope of the present paper; but it can be noted that most of the major problems have to do in one way or another with valuation issues. Congress made a start on these in 1990, when it added a new subchapter to the Code providing special valuation rules for certain transferred business interests, and transfers in trust. But it can go much further than it did. And Congress can be quite draconian in its approach, if it really desires comprehensive reform. For example, Congress in IRC sec. 2702 has said, essentially, that the grantor retained interest in nonqualifying grantor retained trusts is to be valued at zero.[121] That does not mean that

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[120] Budget of the United States, 2001, Table S-11.

[121] See explanation at section B.6, <u>supra</u>.

those interests have a true market value of zero; it only means that Congress has decided that they should be so treated, so as to avoid under-valuation of the interest passing to the donee. A similar "deemed value" approach could be imagined in the valuation of family partnerships: Congress could say that limited partnership interests should be deemed to have a value equal to the proportionate net asset valuation of the partnership assets, regardless of the amount of any discount an appraiser might think should apply for the lack of marketability of such partnership shares. Similarly, Congress could say that any remainder interest in a grantor-retained trust lasting for less than ten years should be revalued as of the time that such remainder interest is finally distributed, with additional gift tax being payable at that time, if the value has risen.

To say that Congress could do these things is not the same as saying that there is any reasonable likelihood that Congress actually will. And because some of the key conceptual guides to valuation have become deeply embedded in the case law, most meaningful reform will probably have to come from Congress, which, unlike the Treasury (and the IRS), has the power to overrule the courts. Because the current Congress' last expression of its views on the transfer tax system was that the system should be repealed altogether, such reform does not seem likely in the short run. But, just possibly, those reforms could be bargained for, perhaps in the company of significant rate relief, as a realistic alternative to transfer-tax repeal.

Again, the analogy to the Tax Reform Act of 1986 seems apt: If Congress were to lower rates and do the sometimes difficult work of closing loopholes, we would end up with what would surely be a better tax, with a broader base, but lower rates, yielding about the same revenue. If Congress were willing to spend some of that revenue, they could do so by increasing the exemption level applying to transfer taxes. Undertaking that reform would do a great deal to relieve the stress felt by owners of small and medium-sized businesses, who have served as the stalking horses for the current effort to repeal the tax. If that is really the group that Congress is concerned about, a combination of rate reduction, loophole closing, and exemption raising will achieve the best result.