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Gifts in Contemplation of Death: Why Can't Section 2035 Simply Die?

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Gifts in Contemplation of Death: Why Can't Section 2035 Simply Die?

*Stephanie J. Willbanks**

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I. Introduction

A foolish consistency may be the hobgoblin of little minds,[1] but a rational consistency surely is a desired goal of any tax system. Without it, horizontal equity – taxing similarly situated taxpayers the same – is diluted and public confidence in the tax system is eroded. Such confidence is critical to the transfer tax system, which relies to a great extent on voluntary reporting and compliance.

Over seventy years ago the Treasury proposed to integrate the estate and gift taxes into one coherent system and to correlate that system with the income tax.[2] Congress, instead, focused on reforming the in-

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1 "A foolish consistency is the hobgoblin of little minds, adored by little statesmen and philosophers and divines." Ralph Waldo Emerson, *Self Reliance*, *in* Essays: First Series 12, 15 (1841).

2 Most commentators agree with these proposals. The proposal to correlate the estate and gift tax rules with the income tax rules for grantor trusts appeared to be more important than integrating the estate and gift taxes. *See, e.g.,* Advisory Comm. to the Treasury Dep't & the Off. of the Tax Legis. Couns., Federal Estate and Gift Taxes: A Proposal for Integration and for Correlation with the Income Tax 2-3 (Comm. Print 1947) [hereinafter Advisory Proposal]; Adrian W. De Wind, *Proposal for Estate and Gift Tax Revision: The Treasury-Advisory Committee Study*, 6 Inst. on Fed. Tax'n 1, 2-4 (1948); Martin M. Lore, *Should Estate and Gift Taxes be Combined? Analysis of Treasury Study,* 85 Tr. & Est. 375, 375-76 (1947); Martin M. Lore, *If Estate and Gift Taxes Are Combined: Analysis of Treasury Study – Part II*, 85 Tr. & Est. 464,

come tax rate structure and the marital deduction to provide similar tax treatment to common law and community property jurisdictions and made no attempt to unify the estate and gift taxes.[3] Twenty years later the Treasury tried again.[4] Income tax reform, once again, pushed the transfer tax proposals onto the back burner, and it was not until 1976 that Congress finally addressed the issue of unifying the estate and gift taxes.[5] The 1976 Tax Reform Act achieved only partial unification, however, and repeated calls for completion of this endeavor have gone unheeded.[6] Congressional failure to act on these proposals is inexplicable

464 (1947); Martin M. Lore, *If Estate and Gift Taxes Are Combined: Analysis of Treasury Study — Part III,* 85 TR. & EST. 571, 574 (1947); Joseph S. Platt, *Integration and Correlation – The Treasury Proposal,* 3 TAX L. REV. 59, 59 (1948); Robert W. Wales, *Consistency in Taxes – The Rationale of Integration and Correlation,* 3 TAX L. REV. 173, 173-74 (1948).

[3] Revenue Act of 1948, Pub. L. No. 80-471, ch. 168, §§ 301, 361, 371, 62 Stat. 110, 114, 116, 125 (1948).

[4] *See* COMM. ON WAYS & MEANS OF THE H.R. REP. & COMM. ON FIN. OF THE U.S. SENATE, 91ST CONG., TAX REFORM STUDIES AND PROPOSALS 329, 335-37 (Comm. Print 1969) [hereinafter WAYS & MEANS STUDIES AND PROPOSALS]. The American Law Institute developed a similar proposal. *See* A. James Casner, *American Law Institute Federal Estate and Gift Tax Project*, 22 TAX L. REV. 515, 516-17 (1967). A Brookings Institute Report made the same recommendation. *See* CARL S. SHOUP, BROOKINGS INSTITUTION, FED. EST. AND GIFT TAXES 127, 127-28 (1966). There were no dissenting voices. *See* Jerome Kurtz & Stanley S. Surrey, *Reform of Death and Gift Taxes: The 1969 Treasury Proposals, the Criticisms, and a Rebuttal,* 70 COLUM. L. REV. 1365, 1365-66, 1374-75 (1970); Don W. Llewellyn, *Estate and Gift Tax Reform. Inter Vivos Transfers with a Testamentary Flavor,* 13 WM. & MARY L. REV. 553, 555 (1972); John H. Young, *Proposed Revisions of the Federal Estate and Gift Tax Laws: The ALI Revisited*, 5 GA. L. REV. 75, 75 (1970).

[5] Tax Reform Act of 1976, Pub. L. No. 94-455 § 2001, 90 Stat. 1846-54 (1976).

[6] *See* 2 OFF. OF THE SEC'Y DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 374, 377 (1984) [hereinafter *Fairness*]; Joseph M. Dodge, *Redoing the Estate and Gift Taxes Along Easy-to-Value Lines,* 43 TAX L. REV. 241, 243-44 (1988); Harry L. Gutman, *A Comment on the ABA Tax Section Task Force Report on Transfer Tax Restructuring*, 41 TAX LAW. 653, 653 (1988) [hereinafter Gutman, *Comment*]; Harry L. Gutman, *Reforming Federal Wealth Transfer Taxes After ERTA,* 69 VA. L. REV. 1183, 1185 (1983) [hereinafter Gutman, *Reforming*]; K. Jay Holdsworth et al., *Report on Transfer Tax Restructuring*, 41 TAX LAW. 395 (1988); Joseph Isenbergh, *Simplifying Retained Life Interests, Revocable Transfers, and the Marital Deduction,* 51 U. CHI. L. REV. 1, 2 (1984) [hereinafter Isenbergh, *Simplifying*]; Joseph Isenbergh, *Further Notes on Transfer Tax Rates,* 51 U. CHI. L. REV. 91, 96 (1984) [hereinafter Isenbergh, *Further Notes*]; W. Leslie Peat & Stephanie J. Willbanks, *A Page of Logic Is Worth a Volume of History: The Treatment of Retained Interests Under the Federal Estate and Gift Tax Statues,* 8 VA. TAX REV. 639, 639-40 (1989); Theodore S. Sims, *Timing Under a Unified Wealth Transfer Tax,* 51 U. CHI. L. REV. 34, 34, 36 (1984); Paul B. Stephan III, *A Comment on Transfer Tax Reform,* 72 VA. L. REV. 1471, 1471 (1986).

given the lack of dissenting voices,[7] the minimal revenue effect,[8] and the existence of other tax simplification proposals.[9]

Much of the commentary following the 1976 Act focused on the need to revise the retained interest provisions in sections 2036, 2037, and 2038.[10] These sections are some of the most complex and confusing provisions of the transfer tax system. Taxpayers can, however, avoid the pitfalls of these sections with careful planning and the assistance of sophisticated estate planners.

Section 2035 presents similar problems of complexity, but it has not received the same attention from commentators.[11] Although Congress removed much of the bite from this section in 1981, it left behind a con-

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7 It is interesting that the 1947 and 1969 proposals are virtually identical to the 1984 Treasury proposal. The ABA and ALI proposals are also similar. *See* Holdsworth et al., *supra* note 6, at 404-10. *See also* Ronald D. Aucutt, *Further Observations on Transfer Tax Restructuring: A Practitioner's Perspective,* 42 TAX LAW. 343, 343 (1989); Dodge, *supra* note 6, at 250.

8 In fiscal year 2018, the federal estate tax raised approximately $22.6 billion and the gift tax raised approximately $1.2 billion for a total of approximately $23.8 billion. This represented about 0.7% percent of the gross revenue collected in that year. *See* DEP'T OF THE TREASURY, INTERNAL REVENUE SERVICE DATA BOOK 3 (2019), https://www.irs.gov/pub/irs-soi/18databk.pdf. There is no data analyzing the revenue impact of these proposals.

9 Proposals to revise section 2035 have been on the drawing board since 1990. *See, e.g.,* Tax Simplification Act of 1991, H.R. 2777, 102d Cong., 1st Sess., § 502 (1991); Tax Simplification Act of 1991, S. 1394, 102d Cong., 1st Sess., § 502 (1991); Tax Fairness & Economic Growth Act of 1992, H.R. 4287, 102d Cong., 2d Sess., § 4702 (1992); Tax Simplification Act of 1993, H.R. 13, 103d Cong., 1st Sess., § 702 (1993); Tax Simplification and Technical Corrections Act of 1993, H.R. 3419, 103d Cong., 1st Sess., § 602 (1993); JOINT COMM. ON TAXATION, JCS-5-97, DESCRIPTION AND ANALYSIS OF TAX PROPOSALS RELATING TO SAVINGS AND INVESTMENT (CAPITAL GAINS, IRAS, AND ESTATE AND GIFT TAX) 16-18 (1997), https://www.jct.gov/publications.html?func=startdown&id=2937; JOINT COMM. ON TAXATION, JCS-19-95, DESCRIPTION OF MISCELLANEOUS TAX PROPOSALS (1995), https://www.jct.gov/publications.html?func=startdown&id=2945; JOINT COMM. ON TAXATION, JCS-21-90, PRESENT LAW AND PROPOSALS RELATING TO FEDERAL TRANSFER TAX CONSEQUENCES OF ESTATE FREEZES (1990), https://www.jct.gov/publications.html?func=startdown&id=3173; JOINT COMM. ON TAXATION, JCS-13-90, FEDERAL TRANSFER TAX CONSEQUENCES OF ESTATE FREEZES 26-27 (1990), https://www.jct.gov/publications.html?func=startdown&id=3158; HOUSE WAYS & MEANS COMM., WRITTEN PROPOSALS ON TAX SIMPLIFICATION 526, 529, 546-547 (1990).

10 *See* Dennis L. Belcher & Mary Louise Fellows, *Report on Reform of Federal Wealth Transfer Taxes,* 58 TAX LAW. 93, 226 (2004); Dodge, *supra* note 6, at 272, 277-280; Gutman, *Comment, supra* note 6, at 672-673; Gutman, *Reforming, supra* note 6, at 1251 n.195; Holdsworth et al., *supra* note 6, at 410-411; Isenbergh, *Simplifying, supra* note 6, at 1, 33; Isenbergh, *Further Notes, supra* note 6, at 91; Peat & Willbanks, *supra* note 6, at 660; Matthew A. Reiber, *Untangling the Strings: Transfer Taxation of Retained Interests and Powers*, 48 AKRON L. REV. 455, 476 (2015); Sims, *supra* note 6, at 43-44.

11 *But see* Peter S. Cremer, *The 1981 Act and Section 2035: Problems and Possibilities,* 35 TAX LAW. 389, 393 (1982); Kelly A. Moore, *Previously Taxed Property Credit and the 2035(b) Gross Up,* 34 S. ILL. U. L.J. 275, 277-78, 287 (2010); Jeffrey G. Sherman,

fusion of tattered remnants. This article proposes that Congress repeal the three-year inclusion rule for gifts of retained interests and further integrate the estate and gift taxes by making the gift tax tax-inclusive. These steps would not only simplify the transfer tax system, they would also enhance its fairness and neutrality.

Admittedly, the increase in the unified credit has rendered the estate tax irrelevant for most taxpayers.[12] Unless or until the estate tax is repealed, reform efforts should continue to simplify its provisions. There is little or no justification for maintaining language and provisions that do not serve the goals of raising revenue, enhancing vertical and horizontal equity, promoting sound economic decisions, and simplifying compliance and enforcement.

Part II of this article briefly traces the history of section 2035.[13] Part III argues for inclusion in the transfer tax base of all gift taxes paid, not just taxes on gifts within three years of death. Complete unification of the transfer tax bases can be accomplished either at the time the gift tax is paid or at the time of death although the better argument is for doing so at the time of the gift. Part IV examines each application of section 2035 and concludes that the rule should be retained only for the special rules of sections 303, 2032A, 6166, and subchapter C of chapter 64 and perhaps transfers of life insurance policies.

II. Historical Development of Section 2035

The federal estate tax is an excise tax on the transfer of property at death. Clever taxpayers can avoid the estate tax simply by making gifts on their deathbeds. To prevent total erosion of the estate tax base, there must be either a gift tax or a provision that includes deathbed transfers in the estate tax base. Otherwise only those who die unexpectedly would ever pay the estate tax. In 1916, when Congress first enacted the modern estate tax, it chose the latter solution.[14] By doing so, Congress planted the seeds of complexity and unfairness that are still bearing fruit today.

Hairsplitting Under I.R.C. Section 2035(d): The Cause and the Cure, 16 Va. Tax Rev. 111, 126 (1996).

[12] The Budget Reconciliation Act of 2017 increased the estate and gift tax exemption amount to $10,000,000 for tax years beginning in 2018 and terminating after 2025. Pub. L. No. 115-97, 131 Stat. 2091 (2017). That exemption amount is adjusted annually for inflation, and in 2020 it is $11,580,000. Rev. Proc. 2019-44, 2019-47 I.R.B. 1093.

[13] The history is colorful and may provide insight into the lingering life of section 2035. For details see Leslie W. Peat, *The Constitutionality of New Section 2035: Is There Any Room for Doubt?* 33 Tax L. Rev. 287, 297-292 (1987). *See also* Heiner v. Donnan, 285 U.S. 312, 332 (1932).

[14] Revenue Act of 1916, ch. 463 § 202(b), 39 Stat. 777-78 (1916).

The original version of section 2035 included in the gross estate all gifts made in contemplation of death.[15] This provision created a rebuttable presumption that transfers by a decedent within two years of death "of a material part of his property in the nature of a final disposition or distribution" were transfers in contemplation of death and included property subject to these transfers in the gross estate.[16] Whether a particular transfer was made in contemplation of death raised serious philosophical questions: Did an 87-year-old man who skipped about clicking his heels in the air contemplate death?[17] What about a man who wore brightly colored neckties?[18] What about a woman who danced the night away at a nightclub?[19] The statutory presumption did not prevent such questions from being litigated.[20] The prize of tax savings made the contest well worth pursuing for most estates.

In response to the spate of litigation, Congress amended the provision and created an irrebuttable presumption that any transfer greater than $5,000[21] made to one person within two years of the decedent's death was made in contemplation of death.[22] The Supreme Court nixed this scheme, holding the irrebuttable presumption unconstitutional as a denial of due process.[23] This left the government to, once again, litigate every case, searching for the decedent's actual but illusive state of mind when making gifts.

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15 *Id.* § 4. The roots of this provision are much deeper, however. *See* Peat, *supra* note 13, at 289.

16 Revenue Act of 1916 § 1(b).

17 Estate of Johnson v. Comm'r, 10 T.C. 680, 685 (1948).

18 *Id*. at 684.

19 Estate of Stowe v. Comm'r, T.C. Memo. 1972-108, 31 T.C.M. (CCH) 432 (1972). *See also* Estate of Fleischmann v. Comm'r, T.C. Memo. 1954-5, 13 T.C.M. (CCH) 362, 366 (1954); Estate of Schmucker v. Comm'r, 10 T.C. 1209 (1948).

20 Heiner v. Donnan*,* 285 U.S. 312, 312, 332 (1932); Off v. United States, 35 F.2d 222, 226 (S.D. Ill. 1929) (Off appeared to be in perfect health at the time of the gift, engaged in vigorous physical labor on his farm, and walked up the stairway to his office in his building almost as readily as his sons.); White v. Comm'r, 21 B.T.A. 500, 506 (1930) (White smoked cigars and drank whiskey; actively involved in church affairs); Crilly v. Comm'r, 15 B.T.A. 389, 392 (1929) (Crilly possessed a keen memory, was optimistic and very cheerful; he was a member of various clubs and organization, attending meetings, dinners, and lunches weekly; he was a hearty eater and never on a diet, frequently attended baseball games and the theater; he played cards regularly with his family up until the time of his death.); Gimbel v. Comm'r, 11 B.T.A. 214, 219 (1928) (Gimbel rode horseback until 1920 and played golf until mid-1921; he died in 1922). *See also* Peat, *supra* note 13, at 290.

21 Revenue Act of 1926, ch. 27 § 302(c), 44 Stat. 70 (1926). Each donor may give a specified amount per donee each year without incurring any gift tax or using up the donor's exemption amount. In 1926, the gift tax annual exclusion was $5,000.

22 *Id.* Congress may also have been led to this result at least in part by the repeal of the gift tax. *See infra* note 24.

23 *Heiner*, 285 U.S. at 312.

The adoption of the federal gift tax in 1932[24] did not obviate the need for the "gifts in contemplation of death" provision in the estate tax. The new gift tax did not remove the substantial benefits to lifetime giving. Taxpayers could still avoid the estate tax, at least in part, because the gift tax rates were only three-fourths of the estate tax rates; the gift tax had its own rate structure and a separate exemption amount; and the gift tax was excluded from the transfer tax base while the estate tax was included.[25] As a result, the "gifts in contemplation of death" provision remained a critical component of the estate tax system.

Congress modified the "gifts in contemplation of death" provision in 1950 by extending the rebuttable presumption to three years and eliminating the requirement that the gift constitute a material part of the decedent's estate.[26] At the same time, Congress created a new irrebuttable presumption that gifts made more than three years before death were not made in contemplation of death.[27] And thus matters remained until Congress unified the estate and gift tax provisions in 1976.[28]

In 1976, Congress substantially unified the gift and estate taxes by creating one rate structure with one exemption amount.[29] At the same time, Congress amended section 2035 by eliminating the "contemplation of death" test and substituting a flat three-year rule of inclusion:[30] all gifts made within three years of death, regardless of the decedent's mo-

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[24] Congress had adopted a gift tax in 1924 that was very similar to the version adopted in 1932. Revenue Act of 1926, ch. 27, § 322, 44 Stat. 85-86; Revenue Act of 1924, ch. 234 §§ 319-24, 43 Stat. 313-16; H.R. REP. NO. 68-179, at 16 (1924); S. REP. NO. 68-398 § 204, at 17 (1924). This gift tax was repealed in 1926, Revenue Act of 1926, ch. 27, § 323 (a)-(b), 44 Stat. 86; H.R. REP. NO. 69-1, at 15 (1926); S. REP. NO. 69-52, at 9 (1926); H.R. REP. NO. 69-356, at 10 (1926); and did not play a role in development of section 2035. Revenue Act of 1932, ch. 209, §§ 501-32, 47 Stat. 245-59; H.R. REP. NO. 72-708, at 27-31 (1932); H.R. REP. NO. 72-1492, at 17 (1932).

[25] For a more detailed explanation of tax inclusivity and tax exclusivity, *see infra* Part III.

[26] Revenue Act of 1950, ch. 994, § 501, 64 Stat. 962 (1950).

[27] *Id.* This irrebuttable presumption is easy to justify on the basis of simplicity and feasibility. It is a clear statutory rule that diminishes the amount of litigation by imposing an absolute barrier to inclusion, much like a statute of limitations imposes an absolute barrier to a stale lawsuit. It does, however, undermine the theory of including gifts in contemplation of death in the tax base. It also adds an element of gambling to estate planning because no one knows when they will die and thus will not know whether a particular transfer will be included in the gross estate until at least three years have elapsed since the time of the gift.

[28] Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001, 90 Stat. 1846-54 (1976).

[29] *Id.* § 2001(e).

[30] *Id.* §§ 2010(e)(5), 2035.

tive, were to be in included in the gross estate.[31] In addition, Congress excluded from the three-year rule gifts that qualified for the gift tax annual exclusion.[32] Finally, and perhaps more significantly, Congress added a subsection to bring into the gross estate all gift tax paid on gifts made within three years of death. This new "gross up" provision, coupled with the unified rate structure and the unified credit, removed most of the incentives for making lifetime gifts.[33]

Unification eliminated the need for section 2035. If gifts were taxed at the same rate as bequests and if the gift tax was included in the transfer tax base, the advantages of deathbed transfers were gone. Congress finally realized this, and five years later it removed the general rule of section 2035 for all but a limited number of cases.[34] Congress had many other tax matters on its agenda in 1981, and it failed to thoroughly consider section 2035. Instead, it merely tacked a new subsection onto section 2035 that restricted the application of the three-year rule to transfers of interests that were subject to sections 2036, 2037, 2038, and 2042.[35]

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[31] The rule could, perhaps, be justified as a move toward simplicity and feasibility. It was, however, unnecessary in light of the fundamental amendment to the transfer tax system occurring at that time. *See infra* Part IV.

[32] Tax Reform Act of 1976, § 2035, 90 Stat. at 1848. At this time the amount of the annual exclusion was only $3,000. Later it was raised to $10,000. Economic Recovery Act of 1981, Pub. L. No. 97-34, § 441(a), 95 Stat. 319, 319 (1981). It is adjusted annually for inflation and in 2019 the amount was $15,000. Rev. Proc. 2018-57, 2018-49 I.R.B. 827.

[33] This is particularly true because section 1015 requires a carryover basis for lifetime transfers while section 1014 provides a step up basis to date of death value for transfers subject to estate tax. At least now there was something for a taxpayer to seriously consider in deciding whether or not to make gifts immediately before death. Despite section 1014, there was still some advantage to lifetime gifts because the gift tax was exclusive, at least for gifts made more than three years before death. See *infra* Part III for a discussion of tax inclusivity and tax exclusivity.

[34] *See* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 424(a), 95 Stat. 172, 317 (1981).

[35] *Id.* The relevant part of the new subsection reads,

(d) DECEDENTS DYING AFTER 1981. –

(1) IN GENERAL. – Except as otherwise provided in this subsection, subsection (a) shall not apply to the estate of a decedent dying after December 31, 1981.

(2) EXCEPTIONS FOR CERTAIN TRANSFERS. – Paragraph (1) shall not apply to a transfer of an interest in property which is included in the value of the gross estate under section 2036, 2037, 2038, 2041, or 2042 or would have been included under any of such sections if such interest had been retained by the decedent.

(3) 3-YEAR RULE RETAINED FOR CERTAIN PURPOSES.- Paragraph (1) shall not apply for purposes of –

(A) section 303(b) (relating to distributions in redemption of stock to pay death taxes),

Congress again simplified section 2035 in the Taxpayer Relief Act of 1997 by removing the now obsolete general rule in subsection (a) and replacing it with the language adopted in 1981 as subsection (d).[36] It also added a new subsection (e), clarifying that transfers from revocable trusts are treated as made directly by the decedent if the decedent was treated as the owner of the trust for income tax purposes.[37] As a result, section 2035 now provides:

> **SEC. 2035 ADJUSTMENTS FOR CERTAIN GIFTS MADE WITHIN 3 YEARS OF DECEDENT'S DEATH.**
>
> (a) INCLUSION OF CERTAIN PROPERTY IN GROSS ESTATE. – If –
>
> (1) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and
>
> (2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036, 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death,
>
> the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.
>
> (b) INCLUSION OF GIFT TAX ON GIFTS MADE DURING 3 YEARS BEFORE DECEDENT'S DEATH.- The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse during the 3-year period ending on the date of the decedent's death.

(B) section 2032A (relating to special valuation of certain farm, etc., real property),

(C) section 6166 (relating to extension of time for payment of estate tax where estate consists largely of interest in closely held business), and

(D) subchapter C of chapter 64 (relating to lien for taxes).

[36] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1310, 111 Stat. 788, 1043 (1997).

[37] *Id.* See *infra* notes 88-92 and accompanying text for an explanation of this issue and its resolution.

(c) OTHER RULES RELATING TO TRANSFERS WITHIN 3 YEARS OF DEATH. –
  (1) IN GENERAL.- For purposes of –
    (A) Section 303(b) (relating to distributions in redemption of stock to pay death taxes),
    (B) Section 2032A (relating to special valuation of certain farms, etc., real property), and
    (C) Subchapter C of chapter 64 (relating to lien for taxes),
    The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the 3-year period ending on the date of the decedent's death.
  (2) COORDINATION WITH SECTION 6166.- An estate shall be treated as meeting the 35 percent of adjusted gross estate requirement of section 6166(a)(1) only if the estate meets such requirement both with and without the application of paragraph (1).
  (3) MARITAL AND SMALL TRANSFERS.- Paragraph (1) shall not apply to any transfer (other than a transfer with respect to a life insurance policy) made during a calendar year to any donee if the decedent was not required by section 6019 (other than by reason of 6019(2)) to file any gift tax return for such year with respect to transfers to such donee.

(d) EXCEPTION.- Subsection (a) shall not apply to any bona fide sale for an adequate and full consideration in money or money's worth.

(e) TREATMENT OF CERTAIN TRANSFERS FROM REVOCABLE TRUSTS.- For purposes of this section and section 2038, any transfer from any portion of a trust during any period that such portion was treated under section 676 as owned by the decedent shall be treated as a transfer made directly by the decedent.

This revision made section 2035 more comprehensible and removed two obvious problems with the section – (1) the inclusion of interests already in the gross estate under sections 2036, 2037, 2038, and 2042,[38]

[38] *See* Sherman, *supra* note 11, at 126 and *infra* Part IV.A.

and (2) the inclusion of gifts made from revocable trusts.[39] This revision does not go far enough, however. Tax inclusivity needs to be extended to all gifts, and there is no need to retain the three-year rule for section 2036, 2037, and 2038 interests that are transferred within three years of death.

III. Taxing the Gift Tax

Although there is some debate about the purpose of the estate tax,[40] there is none about the gift tax. Its sole function is to prevent avoidance of the estate tax.[41] Given this, there is no justification for different tax rates or different tax bases.[42] Recognizing this, the Trea-

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[39] *See infra* notes 88-92 and accompanying text.

[40] The estate tax was originally enacted to produce additional revenue in preparation for World War I. *See generally* Revenue Act of 1916, ch. 463, 39 Stat. 757-58 (1916); S. Rep. No. 64-793, at 1, 3-5 (1916). *See* David Frederick, *Historical Lessons from the Life and Death of the Federal Estate Tax*, 49 Am. J. Legal Hist. 197, 197 (2007). Commentators have debated whether the estate tax has other functions such as redistributing wealth, increasing progressivity, and creating a backstop for the income tax. *See, e.g.,* Aucutt, *supra* note 7, at 344; William Blatt, *The American Dream in Legislation: The Role of Popular Symbols in Wealth Tax Policy,* 51 Tax L. Rev. 287, 348-49 (1996); Dodge, *supra* note 6, at 245; John E. Donaldson, *The Future of Transfer Taxation: Repeal, Restructuring and Refinement, Or Replacement,* 50 Wash. & Lee L. Rev. 539, 541-545 (1993); Christopher E. Erblich, *To Bury the Federal Transfer Taxes Without Further Adieu,* 24 Seton Hall L. Rev. 1931, 1933-38 (1994); Louis Eisenstein, *The Rise and Decline of the Estate Tax,* 11 Tax L. Rev. 223, 237 (1956); Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 Yale L.J. 259, 269-73 (1983); Harry L. Gutman, *A Practitioner's Perspective in Perspective: A Reply to Mr. Aucutt*, 42 Tax Law. 351, 352 (1989); David M. Hudson, *Tax Policy and the Federal Taxation of the Transfer of Wealth,* 19 Willamette L. Rev. 1, 27-28 (1983); Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation,* 104 Yale L.J. 283, 289-97 (1997).

[41] S. Rep. No. 68-398, at 7 (1924); H.R. Rep. No. 69-1, at 15 (1925); S. Rep. No. 69-52, at 8-9 (1926); H.R. Rep. No. 69-356, at 49-50 (1926); H.R. Rep. No. 72-708, at 8 (1932); H.R. Rep. No. 72-1492, at 28 (1932). Some consider the gift tax as also necessary to backstop the income tax. *See* Gutman, *Comment*, *supra* note 6, at 668; Roswell Magill, *The Federal Gift Tax,* 40 Colum. L. Rev. 773, 773 (1940); Robert B. Smith, *Should We Give Away the Annual Exclusion?* 1 Fla. Tax Rev. 361, 373 (1993); John G. Steinkamp, *Common Sense and the Gift Tax Annual Exclusion,* 72 Neb. L. Rev. 106, 110-12 (1993). There is less need to backstop the income tax after the 1986 reforms flattened rates and imposed the income tax at the parents' marginal rates on the unearned income of a minor child. These reforms significantly undermined incentive to shift income to lower bracket taxpayers. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1411(a), 100 Stat. 2095, 2714-15 (1986).

[42] Some would argue that these differences are necessary to encourage gifts, which shift capital to younger and more enterprising taxpayers. *See* Holdsworth et al., *supra* note 6, at 403; Stephan, *supra* note 6, at 1487-88; Sims, *supra* note 6, at 42. Even if gifts do produce this result, and that is by no means clear, the gift tax annual exclusion and the exclusion of gifts from income, section 102, provide significant incentives to encourage gifts. *See* Aucutt, *supra* note 7, at 343; Gutman, *Comment, supra* note 6, at 656-57.

sury first proposed unification of the two systems in 1947.[43] That call went unheeded, and twenty years later the Treasury tried again.[44] Despite support from the American Law Institute and others,[45] the 1969 unification proposal disappeared in the sea of income tax reforms. It was not until 1976 that Congress finally acted on the Treasury's proposal.[46]

Despite appearances to the contrary, the 1976 Tax Reform Act achieved only partial unification of the estate and gift taxes. It did replace the separate rate schedules for gifts and estates with one rate structure, and it did replace the separate exemption amounts for the two taxes with a unified credit. It failed, however, to provide a single set of rules for determining when a transfer is complete. As a result, some transfers, particularly those where the transferor retains an interest, are subjected to both the gift and estate taxes.[47]

More significantly, the 1976 Act retained tax exclusivity for gifts made more than three years before death, thus retaining a significant preference for lifetime gifts. Tax exclusivity occurs when no tax is levied on the amount of tax actually paid. When a gift is made, the donor pays the gift tax with funds other than those transferred to the donee.[48] If the donor gives the donee $1,000,000, the amount of gift tax is $400,000.[49] The donee receives $1,000,000 and the government $400,000. The $400,000 paid to the government is not subject to the gift tax. Because there is no "tax on the tax," the gift tax is considered tax-exclusive.

The estate tax, however, is tax-inclusive; that is, there is a tax imposed on the amount of estate tax that is paid to the government. Consider the same donor who retained her property until her death. Her

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43 ADVISORY PROPOSAL, *supra* note 2, at 17-25.

44 WAYS & MEANS STUDIES AND PROPOSALS, *supra* note 4, at 355.

45 SHOUP, *supra* note 4, at 127-28; Casner, *supra* note 4, at 536, 575; Llewellyn, *supra* note 4, at 553-56; Young, *supra* note 4, at 79-80.

46 Tax Reform Act of 1976, Pub. L. No. 94-455 § 2001, 90 Stat. 1846-54 (1976).

47 WAYS & MEANS STUDIES AND PROPOSALS, *supra* note 4, at 375; Young, *supra* note 4, at 75-77; Holdsworth et al., *supra* note 6, at 403-04; Dodge, *supra* note 6, at 264; *see also* Isenbergh, *Simplifying*, *supra* note 6, at 6 (stating that if gift tax rates and estate tax rates were created alike, there would be no tax advantage); Peat & Willbanks, *supra* note 6, at 663-64 (discussing the distinctions in case law that lead to the initiatives by the A.B.A. Task Force). These transfers are not taxed twice. If an interest is included in the gross estate, it is not considered an adjusted taxable gift for purposes of section 2001 and credit is given for the gift tax paid. The inclusion of these interests in the gross estate, however, means that any post gift tax appreciation is also taxed at the time of death.

48 The donor is primarily liable for the gift tax. Treas. Reg. § 25.2511-2(a).

49 For simplicity's sake, this example ignores the gift tax annual exclusion and assumes that the donor has made gifts equal to or exceeding the applicable exemption amount. Once the donor's taxable gifts exceed the applicable exemption amount, the tax is a flat rate of 40 percent. Tax Reform Act of 1976 § 2001(c).

estate is now $1,400,000, and the amount of the estate tax due is $560,000.[50] Now the donee-beneficiary only receives $840,000, with is $160,000 less than she would have received had the donor-decedent made a lifetime gift. The $160,000 difference is exactly equal to the transfer tax at 40 percent[51] on the amount of the gift tax, *i.e.*, $400,000.

This difference cannot be justified. Since 1947, the Treasury has proposed to include all gift taxes paid in the transfer tax base.[52] Congress, however, only took a small step in that direction in 1976 when it added a new subsection to section 2035 that brings into the gross estate the gift tax paid on gifts made within three years of death.[53] Commentators have argued for complete inclusion of gift taxes paid in the transfer tax base.[54] Failure to do so undermines the neutrality, simplicity, and rationality of the transfer tax system and weakens the case for revision of the retained interest sections.

One goal of any tax system is to preserve, to the extent possible, economic neutrality or at the very least promote rational economic decisions. The tax system should not prefer one transaction to another without strong justifications. Factors other than tax consequences should influence decision making. Although this is not a universal view,[55] it is most desirable in the transfer tax context. Otherwise the form of the transaction prevails over its substance. This creates needless complexity as taxpayers construct elaborate devices to achieve desired tax consequences. It also produces inequality as similarly situated transactions are frequently taxed differently.

Currently, the transfer tax system is not neutral. It creates a decided preference for lifetime gifts over testamentary transactions because the

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50 Her estate includes both the $1,000,000 gift as well as the $400,000 gift tax. Again, the assumption is that the decedent has made transfers exceeding the applicable exemption amount so that the estate tax is a flat 40 percent.

51 This is the marginal rate of tax on transfers over $1,000,000. *See id.*

52 WAYS & MEANS STUDIES AND PROPOSALS, *supra* note 4, at 355. The ALI and commentators agreed. *See* Casner, *supra* note 4, at 531; Russell K. Osgood, *Carryover Basis Repeal and Reform for the Transfer Tax System,* 66 CORNELL L. REV. 297, 303-04 (1981); Kurtz & Surrey, *supra* note 4, at 1374.

53 Tax Reform Act of 1976, Pub. L. No. 94-455 § 2035(c), 90 Stat. 1848-49 (1976). What is now subsection 2035(b) was enacted as subsection 2035(c) in 1976. When Congress restructured section 2035 in 1997, what had been subsection (c) became subsection (b).

54 Isenbergh, *Simplifying, supra* note 6, at 17-18; Peat & Willbanks, *supra* note 6, at 669-70; Sims, *supra* note 6, at 52.

55 Alice G. Abreu, *Taxes, Power, and Personal Autonomy,* 33 SAN DIEGO L. REV. 1, 16-17 (1996); Blatt, *supra* note 40, at 299-301; Graetz, *supra* note 40, at 268; Edward J. McCaffery, *Tax's Empire,* 85 GEO. L.J. 71, 87-88 (1996); Sheldon D. Pollack, *A New Dynamics of Tax Policy?,* 12 AM. J. TAX POL'Y 61, 89-90 (1995); Eric M. Zolt, *The Uneasy Case for Uniform Taxation,* 16 VA. TAX REV. 39, 42 (1996).

gift tax is tax-exclusive for gifts made more than three years before death. A possible rationale for this preference is the belief that lifetime gifts enhance capital formation and risk taking.[56] Unfortunately, there is no real evidence to support or refute this belief.[57] In the absence of strong evidence supporting this belief, repeal of tax exclusivity is preferred.[58]

The failure to make the gift tax completely tax-inclusive increases the complexity of the transfer tax system in two ways. First, complete inclusivity would obviate the need for most of subsection 2035(a).[59] Second, it would permit true unification of the retained interest rules in sections 2036, 2037, and 2038. There is no justification for taxing transfers on more than one occasion. If a gift is complete, that is, if the donor has given up dominion and control,[60] the gift should not be in the gross estate. Conversely, if property is in the gross estate because the decedent retained too much control, the initial transfer should not be considered a completed gift. Whether one adopts a set of "easy to complete" or "hard to complete"[61] rules, the point is to tax each transaction once and only once.

The retained interest sections are the most complex provisions of the transfer tax and most of their nuances are found in the case law and administrative rulings, not in the statute or regulations. As a result, estate planners, especially those who do not devote all their waking hours to studying these sections, can easily run afoul of the rules. Likewise, sophisticated planners whose clients can afford to pay the price, can avoid inclusion under these sections without really giving up any bene-

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56 Holdsworth et al., *supra* note 6, at 403.

57 *See* Gutman, *Comment*, *supra* note 6, at 657.

58 Even if the gift tax becomes tax inclusive, there will still be an incentive in making lifetime gifts as subsection 2503(b)(1) excludes from the gift tax $10,000 (indexed for inflation after 1998) per year per donee per donor. This incentive is offset to some extent by section 1015 which requires the donee to assume the donor's basis in contrast to subsection 1014(a)(1) which gives the heir a step up in basis to the value of the asset at the date of death.

59 *See infra* Part IV.

60 Treas. Reg. § 25.2511-2(b).

61 There are two types of proposals for a unified set of retained interest rules. The first is characterized as "easy to complete" and would tax most transfers as completed gifts rather than in the gross estate. *See, e.g.*, *Fairness*, *supra* note 6, at 378; Holdsworth et al., *supra* note 6, at 405; Gutman, *Comment, supra* note 6, at 674. The "hard to complete" rules would ignore most retained transfers for purposes of gift tax and, instead, include the property in the gross estate. *See* Dodge, *supra* note 6, at 309-10. The argument in favor of the "hard to complete" rules is the need to achieve precise valuation of transferred interests rather than merely estimated values based on presumed, rather than actual, life expectancy and rates of return.

fits.[62] Congressional attempts to prevent estate freezes through provisions such as subsection 2036(c)[63] and chapter 14 (sections 2701 to 2704),[64] have not stemmed the tide and have merely added further complexity to the tax system. The case for repeal of the retained interest sections is strengthened by making the gift tax completely tax inclusive.[65]

The current system of affairs – partial tax inclusivity of subsection 2035(b) – is also arbitrary. The purpose of subsection 2035(b) is to prevent avoidance of the estate tax by removing the preference for making deathbed transfers.[66] This rule, however, can be avoided simply by making transfers earlier than three years before death. Because no one knows exactly when their appointed hour of death will arrive, the best laid estate plans can often go awry. Given that all gifts, except for birthday and holiday presents and the gratuitous transfers incidental to daily life,[67] are part of the owner's estate plan (*i.e.*, they are all made in contemplation of death), they should all be treated the same. Taxpayers should not be forced to gamble or to live with the uncertainty that subsection 2035(b) currently creates. Moreover, taxpayers who die suddenly or unexpectedly by accident or violence should not be penalized.

Finally, the current rules favor the very wealthy who can afford to transfer significant wealth more than three years before death as opposed to the moderately wealthy, those who will be subject to the estate

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62 The most obvious, and most frequently cited, example is the ability of the taxpayer to achieve the same result as a trust with a retained life estate by purchasing an annuity and making a transfer in trust without the retained lift estate. *See* Isenbergh, *Simplifying*, *supra* note 6, at 10; Peat & Willbanks, *supra* note 6, at 652-53. Other techniques include Grantor Retained Annuity Trusts and Family Limited Partnerships or Family Limited Liability Companies.

63 I.R.C. § 2036(c) was enacted in 1986, Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10402(a), 101 Stat. 1330-431 (1987), and repealed in 1990, Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11601(a), 104 Stat. 1388-490 (1990).

64 Chapter 14 was enacted in 1990 to replace subsection 2036(c). Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602, 104 Stat. 1388-491 (1990).

65 *See* Isenbergh, *Simplifying, supra* note 6, at 17-18; Peat & Willbanks, *supra* note 6, at 650-51.

66 Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001, 90 Stat. 1846, 1846-48 (1976); H.R. REP. NO. 94-1380, at 10-17 (1976), *as reprinted in* 1976 U.S.C.C.A.N. 3356, 3364-3369; Technical Corrections Act of 1982, Pub. L. No. 97-448, sec. 104(d), § 424(1), 96 Stat. 2365, 2383 (1983); S. REP. NO. 97-592, at 23 (1982), *as reprinted in* 1982 U.S.C.C.A.N. 4149, 4170. *See also* Peat, *supra* note 13, at 289-292; Sherman, *supra* note 11, at 123-24; RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAX. ¶ 4.07[1], at 4-174 (9th ed. 2013) (republished on Westlaw, FEDERAL ESTATE AND GIFT TAX. ¶ 4.07).

67 These transfers are protected from the three-year rule anyway by the gift tax annual inclusion. Gifts that qualify for the annual exclusion are excluded by subsection 2503(b).

tax but cannot afford to make significant lifetime transfers. One function of the transfer tax system is to enhance progressivity.[68] Subsection 2035(b) undermines progressivity by subjecting the moderately wealthy to higher rates of tax than the very wealthy.

Another possible justification for the tax exclusivity of gifts made more than three years before death is that the differential operates as a discount for early payment of the transfer tax. Professor Sims, however, has demonstrated the falsity of this proposition,[69] and others support his analysis.[70]

The final possible rationale supporting limited tax inclusivity is that preserving the rate differential offsets the stepped-up basis rule of section 1014.[71] According to this argument, most unrealized wealth is owned by the wealthiest taxpayers, the ones who are subject to the estate tax. When these taxpayers make lifetime transfers, the donees receive only a carryover basis[72] so the unrealized appreciation remains subject to the tax. The *quid pro quo* for the carryover basis is a lower tax rate on the gift in the form of tax exclusivity. On the other hand, if the wealthy taxpayer retains the property until death, the heirs receive a step-up basis and the unrealized appreciation goes untaxed.[73] The price for the income tax benefit is an increased rate of tax in the transfer tax system. Only the rate differential created by the tax exclusivity of the gift tax can compensate for this because the nominal rate of tax on gifts and estates is now the same.

This argument has some appeal given the failure of Congress to stand firm on the issue of carryover basis for testamentary transfers. In 1976, when it unified the gift and estate tax systems, Congress also en-

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68 Progressivity is based on the concept that taxpayers with greater ability to pay should shoulder a higher percentage of the burden of taxation. Many commentators argue for progressivity generally. *See e.g.,* JOSEPH A. PECHMAN, FEDERAL TAX POLICY 255 (5th ed. 1987); Abreu, *supra* note 55, at 11; Donna M. Byrne, *Progressive Taxation Revisited*, 37 ARIZ. L. REV. 739, 742 (1995); Donaldson, *supra* note 40, at 543-45; Gutman, *Reforming, supra* note 6; Kurtz & Surrey, *supra* note 4, at 1366; R.A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 47-49 (1967). Commentators additionally argue the estate tax enhances progressivity in the tax system generally. *See* Graetz, *supra* note 40, at 271-72; Gutman, *Reforming, supra* note 6, at 1194. It seems anomalous that the tax exclusivity rule undermines progressivity within the estate tax itself. *See, e.g.*, Abreu, *supra* note 55, at 33; Erblich, *supra* note 40, at 1943; Hudson, *supra* note 40, at 6-7.

69 Sims, *supra* note 6, at 57.

70 Gutman, *Comment, supra* note 6, at 671; Gutman, *Reforming*, *supra* note 6, at 1250-51; Peat & Willbanks, *supra* note 6, at 648; Alvin C. Warren, Jr., *The Timing of Taxes*, 37 NAT'L TAX J. 499 (1987).

71 Stephan, *supra* note 6, at 1482-84. *See also* Holdsworth et al., *supra* note 6, at 403-04.

72 I.R.C. § 1015.

73 *See id.* § 1014.

acted section 1023, which provided for a carryover basis for testamentary transfers.[74] The outcry was swift and vehement,[75] and Congress repealed the section before it took effect.[76] When Congress repealed the estate and generation-skipping transfer taxes in 2001,[77] it once again enacted a carryover basis provision for transfers at death.[78] When Congress reversed course on the repeal, it also eliminated the carryover basis provision.[79]

Taxing unrealized gains as income at death is not a viable alternative.[80] This proposal, like the carryover basis proposal, corrects the defect of the income tax system within that system itself. It does not rely on the transfer tax system to "make it right." Despite the appeal of this proposal, it is subject to the same flaws as the carryover basis proposal.[81] In addition, taxing unrealized appreciation at death appears to be

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[74] Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005(a)(2), 90 Stat. 1872 (1976).

[75] Byrle M. Abbin, *Carryover Basis: Opening Pandora's Box,* 116 TR. & EST. 154, 155 (1977); Blatt, *supra* note 40, at 342, 346-47; Marvin E. Blum, *Carryover Basis: The Case for Repeal*, 57 TEX. L. REV. 204 (1979); H.A. Conway, *Carryover Basis – An Impossible Dream,* 118 TR. & EST. 10 (1979); Gutman, *Reforming*, *supra* note 6, at 1198; Howard J. Hoffman, *The Role of the Bar in the Tax Legislative Process*, 37 TAX L. REV. 411, 413, 444 (1982); Osgood, *supra* note 52, at 297-98, 304-307; David M. Roth, *Transfer at Death of Property Subject to an Indebtedness in Excess of the Decedent's Basis: A Problem With the New Carryover Basis,* 58 B.U. L. REV. 765, 766-770 (1978).

[76] Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 401, 94 Stat. 299, 301 (1980).

[77] Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 501, 115 Stat. 38, 69 (2001).

[78] *Id.* §§ 541–42, 115 Stat. at 76.

[79] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 301, 124 Stat. 3296, 3300 (2010).

[80] Verner F. Chaffin, *Restructuring Federal Estate and Gift Taxes: Impact of Proposed Reforms on Estate Planning,* 69 MICH. L. REV. 211, 232 (1970); Joseph M. Dodge, *Further Thoughts on Realizing Gains and Losses at Death*, 47 VAND. L. REV. 1827, 1837-40 (1994); Charles O. Galvin, *Taxing Gains at Death: A Further Comment*, 46 VAND. L. REV. 1525, 1530 (1993); Gutman, *Comment*, *supra* note 6, at 655; Bernard Okun, *The Taxation of Decedents' Unrealized Capital Gains,* 20 NAT'L. TAX J. 368, 368 (1967); Dan Subotnik, *On Constructively Realizing Constructive Realization: Building the Case for Death and Taxes,* 38 U. KAN. L. REV. 1, 4-5 (1989); Young, *supra* note 4, at 91-92; Lawrence Zelenak, *Taxing Gains at Death,* 46 VAND. L. REV. 361, 363-64 (1993).

[81] The primary complaint was the inability to discern the basis of property once the taxpayer owner was dead. *See, e.g.*, Nancy M. Annick, *Plugging the "Gaping Loophole" of the Step-Up in Basis at Death: A Proposal to Apply Carryover Basis to Excess Property,* 8 PITT. TAX REV. 75, 95-96 (2011); Marvin E. Blum, *Carryover Basis: The Case for Repeal*, 57 TEX. L. REV. 204, 216-17 (1978) (detailing the flaws of a carryover); Joseph M. Dodge, *A Deemed Realization Approach is Superior to Carryover Basis (And Avoids Most of the Problems of the Estate and Gift Tax)*, 54 TAX L. REV. 421, 441-42 (2000); Howard J. Hoffman, *The Role of the Bar in the Tax Legislative Process*, 37 TAX L. REV. 411, 440-41 (1981); Richard Schmalbeck et al., *Advocating a Carryover Tax Basis Regime*, 93 NOTRE DAME L. REV. 109, 115-16 (2017); Zelenak, *supra* note 80, at 367.

taxing the "widows and orphans" when they can least afford it. Despite the safety net of section 121, which prevents taxation of a significant portion of gain in the principal residence and which could be extended to gains realized at death, the perception of unfairness would be great. Given the existence of the estate tax, any attempt to tax unrealized gains at death would seem like double taxation to the general populace. Its political acceptability is highly questionable.

Repeal of section 102, which excludes gifts and bequests from the income of the recipient, might also solve this problem in the income tax context. But this proposal suffers from the same problems as carryover basis and taxing unrealized gains at death. It is also unlikely to happen. If Congress seriously considered repealing section 102, it would most likely also repeal the entire transfer tax system to eliminate the claims of double taxation.

Despite the appeal of this analysis, the need to plug the hole created by section 1014 is outweighed by the need for rationality in the transfer tax system. Extension of tax inclusivity to all gratuitous transfers promotes neutrality, fairness, and simplicity. Given the ease with which taxpayers can avoid the problem, at least to some extent,[82] with careful planning, tax exclusivity needs to be eliminated. Finally, total tax inclusivity will allow much needed revision of the retained interest sections.

There are two methods that achieve total tax inclusivity. One is to include in the gross estate all gift taxes paid; the other is to adjust the gift tax paid at the time of the gift to make it tax inclusive. Professor Sims has demonstrated how this latter approach can be done and why it is preferable.[83] His approach is theoretically preferable as it prevents the underpayment of the tax that results from deferral. It is also preferable from a purely practical point of view; imagine the horror of the heirs who receive little or nothing because the decedent's estate was consumed by the tax paid on prior gifts.[84] If Professor Sims' proposal were adopted, subsection 2035(b) could simply be replaced by a new rate

[82] No one will give all of their wealth away during life. They need to retain some money for their own needs. Purchasing an annuity is also too much of a gamble for most taxpayers. They are simply unwilling to give the insurance company the right to retain the money if they die before their life expectancy. Moreover, experience has shown that most individuals will retain their wealth until death even if they have no need for it. It is human nature to control behavior of others through threat of disinheritance. Witness the hundreds of mystery stories, too numerous to cite in this footnote, predicated on this premise.

[83] Sims, *supra* note 6, at 52-56.

[84] Although perhaps unrealistic because of the human tendency to retain wealth until death, this scenario is nonetheless possible.

schedule for gifts. In addition, as the next part will demonstrate, the need for subsection 2035(a) would be virtually eliminated.

IV. In Search of a Rational Rule

The sole purpose of section 2035 is to prevent avoidance of the estate tax through deathbed gifts. Given the unification of the gift tax with the estate tax, there is a need for such a rule only in two cases: (1) where there is a difference between the value of interest taxed at death and as a gift other than differences attributable to the time value of money and (2) where there is a special benefit conferred by the estate tax depending on the size of the gross estate. Section 2035 currently extends far beyond these two situations.

For purposes of calculating the estate tax, section 2035 includes the gross estate interests which would have been included under sections 2036, 2037, 2038, and 2042 but which were transferred within three years of death. Section 2035 also brings back into the gross estate all transfers made within three years of death for purposes of determining eligibility for section 303 (redemption of stock to pay death taxes), section 2032A (special use valuation), section 6166 (extension of time to pay death taxes), and subchapter C of chapter 64 (lien for taxes). Other than for transfers of life insurance and eligibility for these special benefits, the three-year rule should be repealed.

A. Revocable Trusts

The revocable trust is a common estate-planning device. Individuals do not use revocable trusts to avoid taxes – the individual is considered the owner of the property for income tax purposes and is taxed on any income generated by trust property;[85] the transfer of property into a revocable trust is not a completed gift until property is distributed to someone other than the grantor;[86] and property in a revocable trust is included in the grantor's gross estate.[87] Instead, individuals use revocable trusts to protect and manage their assets; to avoid the cost, delay, and publicity of probate; to provide for an alternative to court appointed guardianship or conservatorship upon incompetency; to avoid ancillary probate; to select the situs of administration of their assets; and to avoid court supervision of trust property in some jurisdictions.

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85 I.R.C. § 676.

86 Treas. Reg. § 25.2511-2(c).

87 None of the suggested reforms to the retained interest provisions would alter the tax treatment of revocable trusts. *See Fairness*, *supra* note 6, at 379; Dodge, *supra* note 6, at 271-72; Gutman, *Comment*, *supra* note 6, at 676; Holdsworth et al., *supra* note 6, at 410; ; Isenbergh, *Simplifying*, *supra* note 6, at 16-19; Peat & Willbanks, *supra* note 6, at 646-48; Young, *supra* note 4, at 130.

There are two different applications of the three-year rule to revocable trusts. The first occurs when an individual transfers her property into a revocable trust and then makes gifts from that trust. If the individual made the gifts outright, those gifts would not be brought back into the gross estate after 1981 merely because they were made within three years of death. If the individual has directed the trustee to make gifts from her revocable trust, the Internal Revenue Service initially took the position that those gifts were brought back into the gross estate under section 2035 as well as subsection 2038(a)(1) unless the individual was the sole beneficiary of the trust.[88] Although the Tax Court initially accepted the Service's position,[89] the Eighth Circuit rejected it.[90] The Service acquiesced and did not litigate the issue further.[91] In 1997, Congress codified this result in subsection 2035(e), which provides that transfers from revocable trusts are treated as transfers made directly by the decedent as long as the decedent is treated as the owner for income tax purposes.[92]

The second application of the three-year rule to revocable trusts arises when the decedent relinquishes the power to revoke within three years of death.[93] If the decedent exercises the power to revoke, the trust property reverts to the decedent. If the decedent owns that property at death, it is in their gross estate pursuant to section 2033. If the decedent gives that property away prior to death, those gifts are not brought back into the decedent's gross estate because section 2035 no longer applies to outright gifts.

The relinquishment of the power to revoke is a completed gift of the trust interests. The decedent has given up dominion and control over the trust property and can no longer change the beneficial enjoyment

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88 TAM 9342003 (June 30, 1993); TAM 9301004 (Sept. 25, 1992); TAM 9226007 (Feb. 28, 1992); TAM 9049002 (Aug. 29, 1990); TAM 9016002 (Apr. 20, 1990); TAM 9015001 (Apr. 13, 1990); TAM 8609005 (Nov. 26, 1985). *See also* Louis S. Harrison, *IRS Rulings Demand More Careful Use of Revocable Trusts to Make Gifts*, 17 EST. PLAN. 332, 335 (1990); Mark A. Segal, *Distributions from Revocable Trusts and Estate Inclusion*, 11 AKRON TAX J. 121, 121 (1995).

89 *See* Estate of Jalkut v. Comm'r, 96 T.C. 675, 684 (1991).

90 *See* Estate of Kinsling v. Comm'r, 32 F.3d 1222, 1227 (8th Cir. 1994); McNeely v. United States, 16 F.3d 303, 305-06 (8th Cir. 1994).

91 Estate of Kinsling v. Comm'r, 32 F.3d 1222 (8th Cir. 1994) *action on dec.*, 1995-06 (Aug. 7, 1995).

92 Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1310, 111 Stat. 788, 1044 (1997).

93 *Id.* at 1043. Section 2038 also applies if the decedent retains the power to alter, amend, or terminate. This power is similar to the power in subsection 2036(a)(2) to determine beneficial ownership of property or the income from that property. These powers are analyzed in the next section.

whether for themselves or others.[94] Those transfers are subject to the gift tax at the time the decedent relinquishes the power to revoke. This is no different than if the decedent had revoked the trust and created a new trust with the same beneficiaries. There is no reason to treat the relinquishment of the power to revoke within three years of death any differently than an outright transfer or the creation of a new trust.

Assume that Decedent had created a revocable trust to pay the income to their Child for the Child's life, and then to distribute the trust property to Child's issue. The Decedent transferred $20 million into the trust. That transfer does not subject the Decedent to the gift tax because the Decedent retained the power to revoke.[95] If the Decedent died, that property would be in the Decedent's gross estate pursuant to section 2038. During Decedent's life, Decedent would be taxed on the income generated by the trust by section 676.

Instead, assume that Decedent has not created the revocable trust, but had created an irrevocable trust to pay Child the income for life and the remainder to Child's issue. Decedent retained no powers over the trust and transferred $20 million into the trust. The creation of the trust is a completed gift. If Decedent died within three years of creating the trust, the trust property would not be in their gross estate.

Now assume that Decedent created the revocable trust described above and released the power to revoke within three years of death. The release of the power to revoke creates a gift. The result is the same as if the Decedent had never retained the power to revoke, and it should be taxed the same.

The same result would occur if the Decedent created the revocable trust described above and exercised the power to revoke within three years of death. Once the Decedent received the trust property, the Decedent would then transfer it outright to Child. That gift would not be brought back into the Decedent's gross estate pursuant to section 2035.

There is no reason to treat the release of the power to revoke within three years of death as a transfer that should require inclusion of the property subject to that power in the Decedent's gross estate. The property subject to the release is taxed as a gift, and there is no need to tax it a second time in the gross estate. Doing so is simply a trap for the unwary and unsophisticated taxpayer or the one that fails to consult a tax attorney prior to releasing the power to revoke.

Substance should prevail over form. Form is important in tax law, and taxpayers should be bound by their choices. Exalting form over substance in this situation, however, is not necessary. There are non-tax-

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[94] Treas. Reg. § 25.2511-2(b).
[95] *See id.*

avoidance reasons for using revocable trusts. Moreover, including multiple beneficiaries in a revocable trust allows efficiencies in trust administration and avoids duplicating costs of retitling property. Taxpayers should not be caught between the benefit of using trusts and the rules of sections 2035 and 2038.

Finally, a revocable trust is the equivalent of outright ownership. If the tax system treats the taxpayer as the owner of the property for income, gift, and estate tax purposes, then is should so do for purposes of section 2035. It is inconsistent for Congress to ignore the virtual ownership by the decedent in section 2035 but recognize it for other sections of the income and transfer taxes.

Initially, section 2035 also included reference to section 2041. Thus, gifts made pursuant to the exercise or release of a general power of appointment were to be brought back into the gross estate if made within three years of death. The reference to section 2041 was deleted from section 2035 in 1982, apparently under the theory that a general power of appointment was virtually the same as outright ownership and if outright gifts were no longer brought back into the gross estate by section 2035, the transfers made pursuant to a general power of appointment need not be brought back either.[96] The outright ownership analysis is at least as strong for revocable trusts as for general powers of appointment; in fact it may be stronger because the property in a revocable trust belonged initially to the decedent whereas the property subject to a general power of appointment was gifted to the decedent by someone else.

The sole purpose of section 2035 is to backstop the estate tax. With the unification of the gift and estate taxes, the only gifts that need to be brought into the gross estate are those where there is a difference in value between the interest gifted and the interest included in the gross estate other than differences based on the time value of money. Gifts from revocable trusts do not present such a difference in value. The only possible difference is the appreciation in value between the time of the gift and the date of death. This is true for outright gifts also, and these gifts are excluded from the reach of section 2035.

B. Powers Held by the Decedent

Section 2038 includes in the gross estate more than revocable trusts; it also brings back into the gross estate any property over which the decedent has made a transfer and retained the power to alter, amend, or terminate the transfer. Subsections 2036(a)(2) and (b) will also bring

[96] Stephens et al., *supra* note 66, ¶ 4.07[2][a]; *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001, 90 Stat. 1872, 1846-54 (1976).

into the gross estate property over which the decedent retains certain powers. If the decedent makes a transfer and retains a section 2036 or section 2038 power and then relinquishes that power within three years of death, subsection 2035(a) will bring into the gross estate the value of the property interest subject to that power.[97]

For example, assume that D establishes an irrevocable trust to pay the income to A for life with the remainder to B and reserves to herself the power to add or delete beneficiaries other than herself. The reservation of power renders the initial transfer incomplete for gift tax purposes and would bring the corpus of the trust into the decedent's gross estate under both subsection 2036(a)(2) and subsection 2038(a)(1). Now assume that D releases her right to change the trust beneficiaries and dies within three years of the release. At the time of the release, D will pay a gift tax because the gift of income to A and remainder to B is now complete. In addition, subsection 2035(a) as well as subsection 2038(a)(1) would bring into D's gross estate the date of death value of the trust corpus simply because D released the power within three years of death.

The case for elimination of section 2035 in this situation may not, at first, appear to be as strong as it is for gifts from revocable trusts. After all, D is no longer the virtual owner of the property. She cannot obtain the property back. D gave up that right by making the initial transfer. This distinction, however, should not make a difference with respect to subsection 2035(a). Once again, D has obtained no tax advantage by creating this trust. D will be considered the owner for income tax purposes;[98] D has not made a completed gift until D releases the power to change beneficiaries;[99] and the date of death value of the trust corpus will be in D's gross estate.[100] For all tax purposes, D is treated as the owner of the property. Because there is no fundamental difference between outright gifts and gifts that result from relinquishment of retained powers, the tax system should treat the release of D's power the same as an outright gift and not subject it to estate tax pursuant to section 2035.

This situation is not precisely the same as a gift from a revocable trust or a gift occurring through exercise of a general power of appointment. D has, in this situation, given up the ability to reacquire the property. The question is this: Is this distinction meaningful for purposes of section 2035? The answer must be no.

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[97] Section 2038(a)(1) also applies to section 2036 powers. Although similar, sections 2036 and 2038 are not co-extensive. *See* Estate of Farrel v. United States, 553 F.2d 637, 640-641 (Ct. Cl. 1977); *see also* Boris I. Bittker, *Transfers Subject to Retained Right to Receive the Income or Designate the Income Beneficiary,* 34 RUTGERS L. REV. 668, 683 (1982).

[98] I.R.C. § 674.

[99] Treas. Reg. § 25.2511-2(b).

[100] I.R.C. §§ 2036(a)(2), 2038.

There is no possibility of tax avoidance here. D pays a gift tax at the time that she releases the power to change the beneficiaries. The value of the gift is the fair market value of the property subject to the power; in this case it is the entire trust corpus. The only thing that escapes the transfer tax is any appreciation in trust assets that occurs between the date the power is released and the date of D's death. The appreciation in value of outright gifts is not subject to further transfer taxation, and there is no need to tax that appreciation in this situation either.

All that subsection 2035(a) does in this situation is create a trap for unwary taxpayers and their attorneys. In fact, given the tax consequences of retaining this type of power, a taxpayer would be better off retaining the right to revoke the entire trust. The taxpayer could then revoke the trust, retitle the property in their own name, and then make an absolute gift of the trust property that would avoid the reach of section 2035.

There are some situations where the decedent can retain a power that is not significant enough to cause her to be treated as the owner for income tax purposes and the gift is considered complete but which will still be sufficient to bring the property back into the gross estate. The power to terminate a trust for one beneficiary is the most obvious example; the power to vote stock in a controlled corporation is another. Because these powers would bring the trust property back into the gross estate pursuant to section 2038 and subsection 2036(b), the release of these powers within three years of death raises the section 2035 issue. The inquiry remains: Are these situations sufficiently distinguishable from outright gifts to subject them to estate taxation?

Once again, the answer must be no. The unification of the transfer tax system removed the need for section 2035 in these situations as well. These transfers were completed gifts at the time the trusts were initially established. The taxpayer paid the gift tax due at that time. The value of the gifts was the fair market value of the trust property with no diminution because of the taxpayer's retained powers. The possibility for transfer tax avoidance is simply not present. There is no more justification for taxing the appreciation in the value of these gifts than outright gifts.

The difficulty here is that although these transfers would be considered outright gifts, the property would still be subject to the estate tax because of the taxpayer's retained powers. It seems inconsistent to require inclusion of the trust property at death but not if the taxpayer gave up the power immediately (or within 3 years) before death. The problem here is not with section 2035; the problem is in the dissonance between the gift tax and the estate tax.

If a gift is complete for purposes of the gift tax no matter what set of rules is adopted, then it should not be brought back into the gross

estate. The ABA recognized this in its 1984 proposal for transfer tax reform and commentators have agreed.[101] The rationale for this rule is that same as for repeal of most of section 2035. Under a unified tax system with identical bases, identical rates and one exemption amount, there is no need to bring transfers subject to the gift tax back into the gross estate.

Courts have long said that the gift tax and the estate tax were *in pari material* and should be construed the same.[102] This was said when the two taxes were separate and distinct systems. The transfer tax system has moved far beyond being merely *in pari material,* and the reforms begun in 1976 should be completed. Repeal of subsection 2035(a) would significantly simplify the tax system and enhance compliance.

C. Interests Retained by the Decedent: Life Estates and Reversions

Section 2036(a)(1) includes in the gross estate the value of property where the decedent has retained the right to the income from the property for life or the right to use, possess, or enjoy that property. This type of transfer has long been considered the quintessential testamentary transfer.[103] According to the conventional wisdom, without subsection 2036(a)(1), the decedent would be able to avoid the estate tax by paying a gift tax only on the discounted value of the remainder interest at the time of the initial transfer and the value of the decedent's life estate would escape transfer taxation.

What happens, given this theory, if a decedent makes a transfer with a retained life estate and then sells their life estate at some later time? In the *United States v. Allen,*[104] Mrs. Allen had transferred property into trust, retaining 3/5 of the income for life. Later, upon advice of

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[101] Holdsworth et al., *supra* note 6. Other commentators agree. *See, e.g.*, Gutman, *Comment*, *supra* note 6, at 674-75; Isenbergh, *Simplifying*, *supra* note 6, at 1; Peat & Willbanks, *supra* note 6, at 652. Even where the commentators support a "hard to complete" rule instead of the "easy to complete" rule of the ABA, they agree that there should be taxation only once. *See* Dodge, *supra* note 6.

[102] Comm'r v. Wemyss, 324 U.S. 303, 306 (1945); Merrill v. Fahs, 324 U.S. 308, 313 (1945); Estate of Sanford v. Comm'r, 308 U.S. 39, 44 (1939); Burnet v. Guggenheim, 288 U.S. 280, 285-86 (1933); Blodgett v. Holden, 275 U.S. 142, 147 (1927), *modified*, 276 U.S. 594 (1928); Lewellyn v. Frick, 268 U.S. 238, 238 (1925); Harris v. Comm'r, 10 T.C. 741, 744-46 (1948), *rev'd in part*, 178 F.2d 861 (2d Cir. 1949), *rev'd*, 340 U.S. 106 (1950); Goodman v. Comm'r, 4 T.C. 191, 194 (1944), *aff'd*, 156 F.2d 218 (2d Cir. 1946); Estate of Sweeney v. Comm'r, 4 T.C. 265, 270 (1944), *aff'd*, 152 F.2d 102 (2d Cir. 1945); Guggenheim v. Comm'r, 1 T.C. 845, 850 (1943).

[103] *In re* Keeney's Estate, 87 N.E. 428, 429 (N.Y. 1909), *aff'd*, 222 U.S. 525 (1912); Vanderlip v. Comm'r, 155 F.2d 152, 154 (2d Cir. 1946); *see also* Peat & Willbanks, *supra* note 6.

[104] United States v. Allen, 293 F.2d 916 (10th Cir. 1961).

counsel, she sold that life estate for its actuarial value.[105] At her death, the Commissioner included the full 3/5 value of the trust in her gross estate less the amount of consideration she actually received on the theory that she did not receive adequate and full consideration for the life estate. The Circuit Court of Appeals agreed, noting:

> It does not seem plausible, however, that Congress intended to allow such an easy avoidance of the taxable incidence befalling reserved life estates. This result would allow a taxpayer to reap the benefits of property for his lifetime and, in contemplation of death, sell only the interest entitling him to the income, thereby removing all of the property which he has enjoyed from his gross estate. Giving the statute a reasonable interpretation, we cannot believe this to be its intendment. It seems certain that in a situation like this, Congress meant the estate to include the corpus of the trust or, in its stead, an amount equal in value.[106]

This reasoning has been applied by the courts in a variety of situations[107] until *D'Ambrosio v. Commissioner*,[108] where a court finally re-

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[105] The purchase turned out to be a poor investment for the purchaser, her son, because Mrs. Allen died unexpectedly shortly after the sale. *Id.* at 917.

[106] *Id.* at 918.

[107] In *Estate of Gregory v. Commissioner,* the decedent widow elected to have her share of community property pass to a trust established by her spouse in exchange for a life estate in all of the community property. 39 T.C. 1012, 1013 (1963). Following *United States v. Allen,* the court held that the decedent widow had not received full and adequate consideration because she had not received an amount equal to what would have been in her gross estate at death. *Allen*, 293 F.2d at 917-18; *See also* Gradow v. United States, 897 F.2d 516, 519 (Fed. Cir. 1990).

In *United States v. Righter,* the decedent and her nephews each transferred stock in a family corporation to a trust to settle a will contest. 400 F.2d 344 (8th Cir. 1968). The decedent received, in consideration for her agreement to transfer her shares to the trust, a life estate in the entire trust. The court held that full and adequate consideration equaled the value of the decedent's shares at the time she transferred them to the trust. *Id.* at 346-48.

In *Pittman v. United States,* the decedent and her spouse conveyed remainder interests in three properties to their daughters. 878 F. Supp. 833, 834 (E.D. N.C. 1994). The court, following *United States v. Allen*, held that adequate and full consideration was "what would have otherwise been included in the estate, not . . . [the value of] the interest transferred." *Id.* at 835.

See also Wheeler v. United States, No. SA–94–CA–964, 1996 WL 266420 (W. D. Tex. Jan. 26, 1996), *rev'd*, Wheeler v. United States, 116 F.3d 749 (5th Cir. 1997); Estate of Magnin v. Comm'r, T.C. Memo. 1996-25, 71 T.C.M. (CCH) 1856 (1996), *rev'd*, Estate of Magnin v. Comm'r, 184 F.3d 1074 (9th Cir. 1999); Parker v. United States, 894 F. Supp. 445, 446 (N.D. Ga. 1995); Mauck v. United States, No. 83-1877-K, 1985 WL 6401 (D. Kan. June 24, 1985).

[108] 101 F.3d 309, 313 (3d Cir. 1996).

alized the fallacy of this argument. In that case D'Ambrosio sold a remainder interest in stock for an annuity. The Commissioner conceded that the value of the annuity equaled the fair market value of the remainder at the time of the sale. The Court distinguished *United States v. Allen* as applying only to life estates and held that the sale of a remainder interest was different. The court reasoned:

> As long as [the taxpayer] sells the remainder for its fair market value, it makes no difference whether she receives cash, other property or an annuity. All can be discounted to their present values and quantified. If she continues to support herself from her life estate, the consideration she received in exchange for the remainder, if properly invested, will still be available for inclusion in the gross estate when she dies, as *Frothingham* and *Gregory* require. On the other hand, if her life estate is insufficient to meet her living expenses, the widow will have to invade the consideration she received in exchange for her remainder, but to no different an extent than she would under the previous hypothetical in which she retained the fee simple interest. In sum, there is simply no change in the date of death value of the final estate, regardless of which option she selects, at any given standard of living.
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> On the other hand, if the full, fee simple value of the property at the time of death is pulled back into the gross estate under 2036(a) subject only to an offset for the consideration received, then the post-sale appreciation of the transferred asset will be taxed at death. Indeed, it will be double-taxed, because, all things being equal, the consideration she received will also have appreciated and will be subject to tax on its increased value. In addition, it would appear virtually impossible, under the tax court's reasoning, ever to sell a remainder interest; if the adequacy of the consideration must be measured against the fee simple value of the property at the time of the transfer, the transferor will have to find an arms-length buyer willing to pay a fee simple price for a future interest. Unless a buyer is willing to speculate that the future value of the asset will skyrocket, few if any such sales will take place.
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> Another potential concern, expressed by the *Gradow* court, is that, under [taxpayer's] theory, "[a] young person could sell a remainder interest for a fraction of the property's [current, fee simple] worth, enjoy the property for life, and then pass it along without estate of gift tax consequences." 11 Cl. Ct. at 815. This reasoning is problematic, however, because it ignores the time value of money. Assume that a decedent

> sells his son a remainder interest in that much-debated and often-sold parcel of land called Blackacre, which is worth $1 million in fee simple, for its actuarial fair market value of $100,000 (an amount which implicitly includes the market value of Blackacre's expected appreciation). Decedent then invests the proceeds of the sale. If the rates of return for both assets are equal and the decedent lives exactly as long as the actuarial tables predict, the consideration that decedent received for his remainder will equal the value of Blackacre on the date of his death. The equivalent value will, accordingly, still be included in the gross estate. . . . We therefore have great difficulty understanding how this transaction could be abusive.[109]

The Court in *D'Ambrosio* was only partially correct. Its reasoning applies with equal force to sales or gifts of life estates. When a decedent makes a transfer retaining only the right to income from the property, the decedent makes a current gift of the remainder interest. The value of the remainder is simply the value of the right to receive property at the time of the decedent's death, discounted to its present value using the applicable discount factor.[110] The decedent will pay a present gift

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[109] *Id.* at 316-17.

[110] *See* Isenbergh, *Simplifying*, *supra* note 6, at 1; Peat & Willbanks, *supra* note 6, at 650.

Valuation of partial interests has become increasingly sophisticated. Originally, the Treasury issued valuation tables in the regulations based on a stated interest rate. *See, e.g.*, Tres. Reg. §§ 20.2031-7, 20.2031-10, 25.2512-9. In times of rapidly changing interest rates, it became possible for taxpayers to manipulate these valuation tables for their own benefit. Congress responded by enacting section 7520, which required the treasury to change the applicable interest rate on a monthly basis. Despite this, the possibility of tax avoidance was still present because a taxpayer could shift value to the remainderman simply by having the trustee accumulate the income rather than distribute it. Congress enacted section 2702 to prevent this type of manipulation. As a result of these provisions, the value of a remainder is the discounted value of the right to receive the property at the taxpayer's death.

Two factors still prevent accurate valuation of remainder interests. First, the decedent can die prematurely or live longer than their actual life expectancy. In individual cases, this can create a significant difference in value. An example is *United States v. Allen*, where the decedent died prematurely thereby diminishing the value of the life estate (to the great dismay of her son who had purchased it) and accelerating the remainder. *See* United States v. Allen, 293 F.2d 916 (10th Cir. 1961). Professor Dodge would adopt a series of "hard to complete" rules in order to prevent this occurrence. Dodge, *supra* at note 6, at 286. If one is concerned about this issue, the Professor Dodge approach is the most accurate way to deal with it. On the other hand, the government deals with a large group of taxpayers and over time the probabilities of premature death or longevity equalize. In addition, the virtues of simplicity and neutrality would seem to weigh heavily against the need to provide precise valuation for each individual decedent.

tax on the value of the remainder. The amount of the gift tax approximates the amount of the estate tax that would have been payable had the decedent retained the property until death discounted to present value using the decedent's life expectancy and the same presumed rate of return used to value the remainder.[111]

The reason that the gift tax is not precisely equal to the present value of the estate tax is a combination of the "tax base effect" and the "bracket effect."[112] The "tax base effect" occurs because the estate tax is tax-inclusive while the gift tax is tax-exclusive. This difference will disappear once the gift tax is also tax-inclusive.[113] The "bracket effect" results from the increase in the tax base of the estate tax that results because the amount of the gift will be less, due to discounting, than the amount included in the gross estate. Moreover, other property will be included in the gross estate at death. Both factors may push some, or all, of the transferred property into a higher tax bracket at death. Any difference in value that is subject to tax at the higher brackets will create the "bracket effect."[114] This "bracket effect" was relatively small under prior tax rates and has disappeared now that the gift and estate tax rates are a flat rate.

Section 2036(a)(1) was necessary in a world without a gift tax because the estate tax could have been avoided simply by transferring property into trust and retaining only a life estate.[115] It was also justified when the gift tax rates were substantially lower than the estate tax rates. Decedents obtained a second chance to use the lower brackets of the two separate tax systems, and there were separate exemption amounts for the gift and estate taxes. The unification of the gift and estate taxes, however, eliminated any need for this section.[116] Once the tax base effect and bracket effect are eliminated, there is no need for subsection 2036(a)(1). This is particularly true given that sophisticated taxpayers can avoid the subsection 2036(a)(1) problem simply by purchasing a

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Second, the discount rate used in valuing the remainder interest might very well not be the rate of return on the trust property over the decedent's lifetime. There is no solution to this problem. However, valuation of interest must occur at a precise point in time for all gift and estate tax purposes. Our system uses the current interest rates for short-term, mid-term, and long-term investments. The assumptions underlying these valuation principles must simply be taken as a given in our imperfect world.

[111] *See* Isenbergh, *Simplifying*, *supra* note 6, at 1; Peat & Willbanks, *supra* note 6, at 644.

[112] These terms were coined by Professor Isenbergh. *See* Isenbergh, *Simplifying*, *supra* note 6, at 8.

[113] *See supra* Part III.

[114] For a thorough discussion of the "bracket effect," see Isenbergh, *Simplifying*, *supra* note 6, at 8-16.

[115] *See id.* at 2-9 for examples demonstrating this principle.

[116] For a more complete analysis see *id.* at 6; Peat & Willbanks, *supra* note 6, at 644.

commercial annuity that is akin to the retained life estate in the property and transferring the remainder of the property that is equivalent to the remainder interest to the beneficiaries as a present outright gift.[117] If the decedent does not want to make a present outright gift of the so-called remainder interest, the decedent can purchase the annuity and create a trust where the income from that property will accumulate until their death. The end result is economically equivalent with no different tax effects.

This analysis applies with equal, or even greater, force to the gift (or even sale) of a life estate within three years of death. Assume that at age 50 the decedent makes a transfer in trust retaining the income for life and then makes a gift of the income interest at age 85 which happens to be within three years of their death. The decedent at age 50 will pay a gift tax on the present value of the remainder and will also, at age 85, pay a gift tax on the present value of the life estate. Under the analysis above it would appear that the decedent is paying a double tax on the value of the life estate at age 85. This tax can be justified on the theory that the decedent has ended their life estate "prematurely" through the gift. The decedent no longer has that income stream to save and accumulate in their estate; neither does the decedent have that income stream to consume and must instead consume other resources. The decedent has thus diminished their estate and should be taxed on the gift.

This does not, however, justify the inclusion of the entire trust property in the decedent's gross estate if they make the gift within three years or their death. The purpose, and the only purpose, of section 2035 is to prevent avoidance of the estate tax by lifetime gifts. Such avoidance simply does not occur when a retained life estate is given away within three years of death. The only element of the property that does escape taxation is the appreciation in the value of the property between the time of the gift and the time of death. There is no more need to tax this appreciation where the decedent has retained a life estate than where the decedent has made an outright gift. To the extent that the appreciation has benefitted the decedent, it has been through increased income which will either be consumed by the decedent[118] or saved and taxed under section 2033 at death.[119] That appreciation has also increased the value of the life estate that is subject to the gift tax.

Reversions present a similar issue. The classic reversion that triggers section 2037 is a transfer into trust to pay the income to A for life

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[117] *See* Bittker, *supra* note 97, at 679; Dodge, *supra* note 6, at 294; Isenbergh, *Simplifying*, *supra* note 6, at 17-18; Peat & Willbanks, *supra* note 6, at 652.

[118] Consumption is the only true form of transfer tax avoidance possible.

[119] Section 2033 taxes all property owned outright by the decedent. Any income saved by the decedent will clearly fall within the scope of this section.

and at A's death to distribute the trust property to the decedent if living, otherwise to distribute it to B. In some actuarially determined number of cases, this transfer will invoke section 2037 because A will predecease the decedent and the trust property will in fact revert to the decedent. In these cases, the decedent will once again own the property outright and that property will be in the decedent's gross estate pursuant to section 2033. Only when the decedent predeceases A will section 2037 bring into the decedent's gross estate the full value of the trust property less the value of A's outstanding life estate.[120] This section, like section 2036, needs amendment; however, the cure for section 2037 is not quite as simple as the cure for section 2036.[121]

If section 2037 were repealed and the full value of the trust corpus taxed as a gift,[122] there would be no need to tax the gift of the decedent's reversion within three years of death under section 2035. That reversion would have been fully taxed at the time the trust was created. In this situation, the decedent's transfer plus reversion would be treated the same as any outright gift.

If section 2037 were repealed and the decedent's reversion ignored for transfer tax purposes,[123] there would again be no need for section 2035. If we are willing to ignore the decedent's reversion when they retain it until death, we should also be willing to ignore it when they give it away prior to death.

Finally, if a "wait and see" approach were adopted,[124] the value of the income interest could be taxed either annually as the income is paid to A or as a completed gift at the time the trust is established. The first possibility is analogous to a revocable trust or even to outright ownership of the property. The decedent is taxed annually on the income from the trust; there is no completed gift of the trust corpus; and the full value of the trust property would be in the decedent's gross estate at death.

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120 Stephens et al., *supra* note 66, ¶ 4.09[6].

121 The various possibilities for revising section 2037 are analyzed in Peat & Willbanks, *supra* note 6, at 665-69; *see also* Holdsworth et al., *supra* note 6, at 411; *Fairness*, *supra* note 6, at 377-82; Isenbergh, *Simplifying*, *supra* note 6, at 17-18; Dodge, *supra* note 6, at 267-68; Gutman, *Comment*, *supra* note 6, at 676.

122 *See* Peat & Willbanks, *supra* note 6, at 669-70. This revision of section 2037 in essence ignores the decedent's retained reversion. Although problematic theoretically, it is a very practical solution to the problems presented by section 2037.

123 *Id.* at 669. This revision of section 2037 is perhaps the most unrealistic because it allows the decedent's reversion to totally escape taxation. Like the prior suggested revision, it is a practical solution to the problem.

124 The "wait and see approach" is more fully described in Peat & Willbanks, *supra* note 6, at 670. This approach would require the Service to wait until actual events happened before it imposed a transfer tax.

If the decedent in this situation made a gift of their reversion, the need to "wait and see" would vanish, and the full value of the trust corpus would be taxed at that point as a gift under the unified tax system. This is exactly what happens if the decedent had owned the property outright. If there is no need for section 2035 to bring the value of the property back into the gross estate when it is owned outright, there is no need to do so if section 2037 treats the decedent in the same way. The possibility for tax avoidance simply does not exist in this situation.

If the income were taxed as one completed gift at the time the trust was established, the decedent would be treated as if they had retained the full remainder interest, not just the reversion that is contingent on surviving A. If the decedent had in fact, as opposed to the "wait and see" approach under a modified section 2037, retained the full remainder interest, that remainder interest would be in the decedent's gross estate at death under section 2033, not under sections 2036, 2037, or 2038, because that interest would pass from the decedent to another as a result of the decedent's death. If the decedent gave that remainder interest away, the decedent would pay a gift tax, and only a gift tax, as a result. Section 2035 would not bring that remainder interest back into the decedent's gross estate. The same analysis should keep the remainder out of the decedent's gross estate if section 2037 were modified. Again, there is no possibility of tax avoidance through the gift of a retained reversion and section 2035 becomes completely unnecessary.

What, then, if section 2037 were not modified? In its current rendition, section 2037 would include in the decedent's gross estate the full value of the trust property, less A's outstanding life estate, as long as the decedent's reversionary interest exceeded 5% of the value of the trust property immediately before the decedent's death. Section 2035 would be triggered if the decedent gave away their reversion and then died within 3 years of that gift.

Does the gift of the decedent's reversions present an opportunity for tax avoidance in this situation? The answer, again, is no. The value of the decedent's reversionary interest depends not only on the value of the trust property and an assumed rate of interest, as do the values of life estates and reminders, but also on the probability that the decedent will survive A. That probability will vary depending on whether the decedent is older or younger than A as well as the difference in their ages. Thus, in some cases the decedent's reversion will increase in value as the decedent grows older and in others is will decrease in value. But this is irrelevant. The decedent's reversion is simply one piece of the full reminder interest. All the pieces are being taxed under the unified transfer tax system at the same rate either at the time the trust was created or when the reversion was given away. Once again, the difference in value

is due to the passage of time and the time value of money. There is simply no need for section 2035 to bring the entire value back into the gross estate.

D. Life Insurance

Life insurance presents a different situation. The value of a gift of term life insurance is simply the unused premium, and the value of a gift of cash value insurance is the unused premium plus the cash surrender value (otherwise known as the interpolated terminal reserve).[125] The estate tax value is the amount received by the beneficiary. The gift tax and the estate tax values can be significantly different and, thus, life insurance is the one situation where section 2035 appears necessary to protect the tax base.[126] For example, assume that the decedent owns term life insurance with a face amount of $1 million and the premium for that insurance is $1,000 per year. If the decedent gave away the policy at the beginning of the term, the value of the gift would be a mere $1,000. If the decedent died 6 months later, the decedent would have removed $1 million from their estate at a minimal gift tax cost.[127] If the insurance were cash value instead of term, the gift tax value would increase by the cash surrender value. Except for cash value policies that are fully paid up, there will always be a difference – in some cases small and in some cases large – between the gift tax and the estate tax values. Retention of the rule which includes these transfers in the estate tax base at the date of death value, *i.e.,* the face amount of the policy, therefore, makes sense.

Upon closer examination, however, the need for section 2035 for gifts of life insurance does not rest upon unassailable ground. Even in the realm of life insurance, careful planning can avoid inclusion under section 2035. First of all, for paid up cash value policies there is little, if any, difference in value between the gift tax value and the amount included in the gross estate. Any difference is due to the increased value of the policy due to interest and dividends accumulating in the policy. This is analogous to the increased value of any property due to appreciation. We do not include that appreciation in the tax base where the decedent has made a gift of the property within three years of death, and we do not need to do so for life insurance. As with retained life estates,

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[125] Treas. Reg. § 25.2512-7.

[126] The other situations – sections 303, 2032A, 6166 and chapter 64 – do not affect the decedent's tax base directly. In all these situations, the size of the decedent's gross estate (or adjusted gross estate, as the case may be) determines eligibility for special tax benefits. *See infra* Part IV.E.

[127] If that were the decedent's only gift to that donee during that year, there would be no gift tax cost at all because of the gift tax annual exclusion. I.R.C. § 2503(b).

the payment of the gift tax earlier rather than later compensates for this difference in value.

Secondly, if the decedent makes a gift of money to the intended beneficiary of the life insurance policy and that intended beneficiary purchases the policy on the life of the decedent, the life insurance proceeds are not in the decedent's gross estate even if the purchase was made within three years of death.[128] Thus, the decedent can do indirectly through a purchase by the intended beneficiary what they cannot do directly by transferring an existing policy to the beneficiary.

Finally, a transfer of a life insurance policy more than three years before death escapes taxation in the gross estate. Decedents who seek estate planning advice early enough are able to take advantage of the three-year cut off. As a result, section 2035 only impacts those decedents who die unexpectedly or who leave their estate planning until too late to avoid the three-year rule. This seems like a very odd tax rule and perhaps we should simply let section 2035 die even with respect to gifts of life insurance.

E. Special Benefits Sections

Section 2035 does have one other purpose. It brings all transfers within three years of death into the gross estate for the purposes of sections 303(b), 2032A, and 6166 as well as subchapter C of chapter 64. Section 303(b) treats a distribution to a shareholder of a corporation as an exchange of stock, thus permitting capital gains treatment, as long as the value of all of the decedent's stock in that corporation exceeds 35% of the value of the gross estate over the amounts deductible under sections 2053 and 2054. Section 2032A allows qualified real property to be valued at its qualified use, farming or trade, or business, rather than its full fair market value as long as 50% or more of the adjusted value of the gross estate consists of real and personal property being used by decedent for the qualified use and 25% or more of the adjusted value of the gross estate consists of real property being used by the decedent for the qualified use. Section 6166 allows the decedent's estate to defer the time for payment of the estate tax for 5 years and extend the payments over 10 years if the value of an interest in a closely held business exceeds 35% of the adjusted gross estate. Finally, subchapter C of chapter 64 imposes a lien on property for any unpaid tax but provides special rules for the estate tax deferred under section 6166 or the additional estate tax attributable to section 2032A.

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[128] *See, e.g.*, Estate of Headrick v. Comm'r, 918 F.2d 1263 (6th Cir. 1990); Estate of Leder v. Comm'r, 893 F.2d 237 (10th Cir. 1989); Estate of Nepstad v. United States, No. A3-89-54, 1991 WL 117430 (D. N.D. Jan. 8, 1991); Estate of Litman v. United States, No. 89-1302, 1990 WL 208682 (W.D. Pa. Apr. 23, 1990); Sherman, *supra* note 11, at 135-36.

These sections all confer special benefits upon the decedent's estate measured by the value of certain property within the gross estate. As a result, the decedent could qualify for these benefits simply by giving away non-qualifying property on their deathbed. A three-year inclusion rule is necessary to prevent this type of blatant tax avoidance and preserve the special benefits of sections 303, 2032A, and 6166 for the decedents that Congress intended to benefit. Decedents who did not own sizeable amounts of qualifying property during their lives should not be able to distort their estates through deathbed gifts in order to qualify. Thus, a three-year inclusion rule is necessary for these purposes. But these are the only purposes, in addition to gifts of life insurance, for which it is really necessary. A separate section is not necessary to accomplish this goal. Each of these sections could be amended to specifically include property transferred within three years of death in the calculation.

V. Conclusion

Once upon a time section 2035 was necessary to slay the dragon of tax avoidance. That dragon has been terminally ill since 1976 when Congress unified the estate and gift taxes. If Congress would finally kill the dragon by making the gift tax tax-inclusive, there would be no need for section 2035 to bring transfers of retained interests into the tax base. These transfers do not create any opportunities for tax avoidance different from outright gifts of property. Any difference in value between the gift and the property at the time of death is either due to appreciation or to the time value of money. If we are willing to ignore the appreciation in value of outright gifts, we should be willing to ignore it for gifts of retained interests. And the time has finally come to recognize the time value of money as the court in *D'Ambrosio* did. The repeal of section 2035 is one small step toward enhancing simplicity, neutrality, and fairness in the transfer tax system and removing traps for unwary and unsophisticated taxpayers.

The statutory revisions are minimal. First, section 2035 would be deleted. Second, a new gift tax rate schedule would be enacted that would make the gift tax tax-inclusive. Third, a provision including all transfers made within three years of death would be incorporated into sections 303(b), 2032A, 6166 and the sections defining liens. These few changes would greatly simplify the Code as well as enhance its neutrality and fairness. Of course, if Congress were willing to take this step, it would probably also be willing to amend sections 2036, 2037, and 2038

to create a more rational set of retained interest rules and achieve true unification of the estate and gift tax systems.[129]

[129] Unfortunately, these steps would not completely unify the transfer tax system. Section 2040 still includes in the gross estate the value of property owned as joint tenants with the right of survivorship even though that property had been subject to earlier gift tax. *See* Stephanie J. Willbanks, *Taxing Once, Taxing Twice, Taxing Joint Tenants (Again) at Death Isn't Nice*, 9 PITT. TAX REV. 1, 20-21 (2011).