What's Wrong with a Federal Inheritance Tax?

Wendy Gerzog
Abstract:

Scholars have proposed a federal inheritance tax as an alternative to the current federal transfer tax system, but there are serious flaws with that idea. Those problems include: (1) different tax rates and exemptions based on the decedent’s relationship to the beneficiary; (2) the lack of a tax on lifetime gratuitous transfers, including gifts with retained interests or control; (3) the persistence of most current valuation distortion abuses; and (4) significantly decreased compliance rates and increased administrative costs inherent in a system that taxes transferees on transactions that may be largely unmonitored.

This article reviews common characteristics of existing inheritance tax systems in our U.S. states and internationally, particularly in Europe. In addition, the article analyzes the novel Comprehensive Inheritance Tax (CIT) proposal of Professor Batchelder that combines some elements of existing inheritance tax systems with some features of the current transfer tax system and delivers the CIT through the federal income tax system.

Inequities abound in typical inheritance tax systems where rates and exemptions are tied to the relationship between the transferor and the transferee. Moreover, the lack of a tax on lifetime transfers produces inequities since it is the very wealthiest of decedents who are most able to avoid an inheritance tax through early lifetime gifts. Finally, most compelling are the compliance issues that would increase with the adoption of a federal inheritance tax. The current estate and gift tax system focuses on a very small number of wealthy donors and decedents whose returns are all reviewed by the IRS. A federal inheritance tax, which taxes beneficiaries, would greatly increase the number of required returns. Further, our history with unreported tip income provides a taste of the difficulty of enforcement in the area of family gifts.
Table of Contents

I. Introduction
II. Existing Inheritance Tax Systems
   A. Inter Vivos Transfers
   B. Rates
   C. Exemptions for Specific Types of Property
   D. Transfers to Charity
   E. Transfers to Spouse
III. The Comprehensive Inheritance Tax (CIT) Proposal
IV. Behavior
V. What a Federal Inheritance Tax Offers a Transfer Tax
VI. Conclusion
What's Wrong with a Federal Inheritance Tax?  
© Wendy C. Gerzog*

I. Introduction

Periodically, scholars have proposed alternatives to the current federal transfer tax system. One of those proposals has been for the U.S. to adopt a federal inheritance tax. While there are positive aspects of an inheritance tax, there are equity and compliance issues that ultimately would plague and undermine that alternative tax.

A fundamental problem with existing inheritance tax systems is their reliance on different treatment based on the decedent’s relation to a beneficiary. This emphasis is objectionable on fairness considerations. Why should the familial identity of the beneficiary matter? What public policy concerns are fostered by preferring either closely related or unrelated recipients of the decedent’s assets? With the possible exceptions of the surviving spouse, who may have shared in acquiring decedent’s property, and minor children, whom decedent was required to support in

* I wish to thank Professors Mary Louise Fellows, Anthony Infanti, Kerry Ryan, Theodore Seto, Jane Schukoske, and the participants at the following conferences for their very helpful comments: 2012 AALS Annual Meeting, 2012 Critical Tax Theory Conference at Seton Hall Law School, the 2013 Law & Society Annual Meeting, Tax Law and Society 12: Taxing Wealth Transfers (Sponsored by CRN31 Law, Society, and Taxation).  

1 The federal transfer taxes include the gift tax, the estate tax, and the generation-skipping transfer tax. See Joseph M. Dodge, Wendy C. Gerzog, Bridget J. Crawford, Federal Taxation on Gratuitous Transfers: Law and Planning, Ch.2 (Wolters Kluwer Law & Business (Aspen) 2011) [Federal Taxation on Gratuitous Transfers]; Alternatives to the Current Federal Estate Tax System, Hearings Before the Senate Comm. on Finance, 110th Cong., 2d Sess. 1017 (2008) [2008 Hearing on Alternatives](Statements of Professors Lily Batchelder, Joseph Dodge, and David Duff); Id. at 76 (Statement of Joseph Dodge) (“There are five possible alternatives to the current estate, gift, and generation-skipping system: (1) classic inheritance tax (2) accessions tax (3) income-inclusion approach (4) deemed-realization-at-gift-or-bequest-approach (5) carryover basis approach.” Id.); Joseph M. Dodge, Alternatives to the Current Federal Wealth Transfer Tax System (with Joseph Kartiganer and Sherwin Kamin), published as Appendix A to Tax Force on Federal Wealth Transfer Taxes, Report on Reform of Federal Wealth Transfer Taxes, 58 The Tax Lawyer 93, 279-312 (2004).  

2 See 2008 Hearings, supra id. at 77 (Statement of Joseph Dodge) (“An inheritance tax distorts bequest choices by creating tax incentives in favor of certain classes of legatees. An inheritance tax also creates an incentive for the dispersion of wealth among legatees, but such an incentive isn’t especially needed in contemporary American legal practice and culture, which has generally abandoned primogeniture.” Id.); Gerald Jantscher, Aims of Death Taxation, Death, Taxes and Family Property (Edward Halbach, ed.) (1977), excerpted in Federal Taxation on Gratuitous Transfers, supra note 1, at 23, 26 (“One of the most common features of the inheritance tax is the graduation of rates according to the relationship between the decedent and the recipient.” Id.).
life, isn’t the identity of a beneficiary an inherently personal and private matter? Should the passage of wealth to only certain beneficiaries be encouraged?³

Apart from their charitable gifts,⁴ most wealthy decedents leave their property to other wealthy individuals⁵ and the majority of beneficiaries are decedent’s close relatives.⁶ For the comparatively few estates with non-relative heirs, there is no policy rationale to support subjecting those few unrelated individuals to either a higher or to a lower tax rate. Although some have supported lower rates for gratuitous transfers to more distant relations or to unrelated beneficiaries as supporting the redistribution of wealth, the goal of “breaking up large estates” more logically refers to taxing wealthy decedents’ estates and producing additional revenue that will pass to the government to be spent for the “public good” or that will result in marginally⁷ lower taxes on the working poor and on the middle class. The reduction of concentrated family wealth and its associated power cannot realistically be achieved by a system that distinguishes

---

³ While genetic evolution theory, or a primal urge to protect one’s lineal descendants, may explain giving a preference to passing wealth to one’s lineal descendants, the goal of equity as an objective from a tax policy standpoint does not similarly require basing a tax system on that rationale. See Theodore P. Seto, Intergenerational Decision Making: An Evolutionary Perspective, 35 Loy. L.A. L. Rev. 235, 265 (2001) [Seto] (describing the biological concept of kin selection: “Its relevant premise, however, is that we are motivated to care about others because we share genes with them. If this premise is carried to its logical conclusion, the strength of our motivation to care should depend on the extent to which we share genes. Thus, we should care more about our children than about our cousins, more about our cousins than about strangers, and more about strangers than about nonhumans.” Id.).

⁴ See Part II.D.

⁵ See Aviva Aron-Dine, Commentary Trade-Offs in Choosing between an Estate Tax and an Inheritance Tax, 63 Tax L. Rev. 265, 266 (2009) (“Thus, the effect is likely to be on the distribution of wealth among the very wealthy. I do not think we can reasonably expect much effect on inequality between the top and the bottom, or the top and the middle.” Id.) [Aron-Dine].

⁶ With either a transfer tax or an inheritance tax that provides large exemptions, the recipient’s basic needs, in relation to the general population, are much more than adequately met. See Michael Udell, Commentary Wealth Transfer Taxes: Benefits, Burdens, and Bases, 63 Tax L. Rev. 215, 218 (2009) [Udell]; Lily L. Batchelder, What Should Society Expect from Heirs? The Case for a Comprehensive Inheritance Tax, 63 Tax L. Rev. 1, 16 (2009) [Batchelder]; Anne L. Alstott, Commentary Family Values, Inheritance Law, and Inheritance Taxation, 63 Tax L. Rev. 123 (2009).

⁷ The revenue from taxes on wealth transfers is not likely to be sufficient to result in significant tax reductions for lower bracket taxpayers because, with large exemptions, there are relatively few taxpayers to tax. See Michael J. Graetz, To Praise the Estate Tax, Not to Bury It, 93 Yale L.J. 259, 269-270 (1983); Federal Taxation on Gratuitous Transfers, supra note 1, at 24.
tax rates based on a fairly small number, or on the lack of or more distant familial relationship identity, of decedent’s beneficiaries.\(^8\)

Another major problem with a pure inheritance tax system is that it lacks the “back up” of a gift tax on *inter vivos* transfers.\(^9\) To respond to this problem, some countries have implemented gift taxes.\(^10\) There are six states in the United States with an inheritance tax,\(^11\) but there are only two states with a gift tax and those states, Connecticut and Minnesota,\(^12\) do not have an

---

\(^8\) Louis Kaplow, *On the Taxation of Private Transfers*, 63 Tax L. Rev. 159, 178 (2009) (“bequests would to an extent be random windfalls and thus might be subjected to confiscatory taxation and redistribution, the former not having any behavioral effect.”) [Kaplow]; See Joint Committee on Taxation, Description and Analysis of Alternative Wealth Transfer Tax Systems 17 (JCX-22-08), March 10, 2008 [2008 Joint Committee print], available at: [https://www.jct.gov/publications.html?func=fileinfo&id=1318](https://www.jct.gov/publications.html?func=fileinfo&id=1318) (“Studies have found that more than two-thirds of testate decedents with multichild families divide their estates exactly equally or very close to equally.” Id.). Yet, equal division of very large estates means that each child receives a very large windfall and that family wealth is still family wealth.


\(^10\) See 2008 Joint Committee print, *supra* note 8, at 7-9 (Finland, Germany, Ireland, and Spain).

\(^11\) Those states are: Iowa (Iowa Code Ann., Title X, Subtitle 3, Ch. 450); Kentucky (Baldwin's Ky. Rev. St. Ann., Title XI, Ch. 140); Maryland (Md. Code Ann., Tax-Gen., Title 7, Subtitle 2); Nebraska (Neb. Rev. St. Ann., Ch. 77, Art. 20); New Jersey (N.J. Stat. Ann., Title 54, Subtitle 5, Pt. 1, Ch. 33-36); Pennsylvania (Purdon's Pa. St. & Consolidated St., Title 72, Ch. 5, Art. XXI). Since 1989, although Tennessee nominally retained an inheritance tax, that tax makes no distinctions on rates or exemptions because of the beneficiaries relation to the decedent, and its progressive rates are dependent on the estate’s value, ranging from 5.5% to 9.5%. Tenn. Code Ann. §§67-8-314(a), 67-8-316. Because the tax more closely resembles an estate tax, Tennessee is not included as a state with an inheritance tax. Tennessee’s “inheritance” tax is repealed for decedent’s dying after 2016. Tenn. Code Ann. §67-8-314(b). Indiana’s inheritance tax (Ind. Code Ann., Title 6, Art. 4.1, ch.2) was recently repealed for decedents dying on or after January 1, 2013. Likewise, in 2012, Oregon eliminated its inheritance tax and substituted a state estate tax, applicable to decedents dying on or after January 1, 2012. [www.oregon.gov/dor/bus/pages/inheritance.aspx](http://www.oregon.gov/dor/bus/pages/inheritance.aspx).

\(^12\) Judith Lohman, Legislative History of the Connecticut Estate Tax Since 2001, OLR Research Report, 2010-R-0226 (“In 2005, Connecticut revamped its taxes on inheritances and gifts. It repealed the succession tax, which it was already phasing out, and it combined the state estate and gift taxes into one transfer tax with the same rates.”)[Lohman], available at [http://www.cga.ct.gov/2010/rpt/2010-R-0226.htm](http://www.cga.ct.gov/2010/rpt/2010-R-0226.htm). The Connecticut gift and estate taxes replicate their federal transfer tax counterparts, but with lower exemption levels and rates (total of $2M gift or estate exemption and maximum rate of 12 percent). PA 05-251. See Table 5, Lohman. Connecticut’s succession tax was a typical inheritance tax: “Whether the tax applied and at what tax rate depended not only on the value of the inheritance but also on the relationship of the heirs to the decedent.” Id. There were four classes of heirs with the lowest rates applicable to decedent’s closest relatives and with the highest ones on decedent’s distant relatives and unrelated persons. Id. Recently, Minnesota enacted a state gift tax in its 2013 Omnibus Tax Act (House File 677 Art. 7) effective for gifts after June 30, 2013 (subjecting the excess of $1M in aggregate lifetime and testamentary transfers to its state transfer taxes). The purpose of enacting the state gift tax was “to complement or back up the Minnesota estate tax.” Conference Committee Report (CCHRHF0677) at 28. See [http://www.house.leg.state.mn.us/hrd/bx/88/HF0677.pdf](http://www.house.leg.state.mn.us/hrd/bx/88/HF0677.pdf); [http://www.house.leg.state.mn.us/bills/billnum.asp?Billnumber=HF677&is_year=88&session_year=2013&session_number=0](http://www.house.leg.state.mn.us/bills/billnum.asp?Billnumber=HF677&is_year=88&session_year=2013&session_number=0).
inheritance tax (although they do have a state estate tax.)\textsuperscript{13} Some states, however, do include some lifetime transfers in their inheritance tax regimes, but outright gifts, not in contemplation of death or within a few years of death, are not subject to any state inheritance tax.\textsuperscript{14} That means that the very wealthiest of individuals who have many times the funds necessary to maintain a high standard of living and cover their unexpected expenses are most able to avoid an inheritance tax through early lifetime gifts.

Compounding this problem is that inheritance taxes don’t generally include gifts over which the decedent retained control until, or shortly before, his death despite that those transfers may well be described as testamentary. Yet, wealthy individuals are more likely to make lifetime transfers when they can retain control over the transferred property during their lifetimes. That exemption of lifetime gifts with retained powers from inheritance tax systems contrasts sharply to the inclusion of such transfers under the current estate tax provisions, Code sections 2036 and 2038. Those provisions require that transfers with retained control are subject to estate taxation and in so doing, they function as important anti-abuse mechanisms.

Because many state inheritance tax systems depend heavily on the current transfer tax system for pivotal definitions, any new system would likely need to borrow or replicate much of the law and language of the current transfer tax system.\textsuperscript{15} Specifically, various state inheritance

\begin{enumerate}
\item See Part II. A, infra.
\item See, e.g., Batchelder, supra note 5, at 65 (“Despite this fundamental change in the form of wealth transfer taxation, the proposal would continue to rely on much of the extensive body of laws, regulations, and guidance that have been developed under the U.S. estate tax system. For example, the existing rules governing when a transfer has occurred, how it is valued, and what transfers are taxable would remain unchanged. The proposal would not tax a large portion of wealth transfers, as under current law.” Moreover, Professor Batchelder states “To the extent that the current tax treatment of accrued gains, generation-skipping transfers, income in respect of a decedent, illiquid assets, charitable contributions, and gifts made during life for education and medical expenses are considered desirable or politically necessary, these exemptions could be maintained.” Id.)
\end{enumerate}
statutes use federal law definitions to qualify for marital and charitable deductions. Likewise, at least one state statute cites to the federal gift tax annual exclusion and spousal gift splitting statutes.

The thorniest questions and abuses in the transfer tax area involve valuation distortion. For the most part, those difficulties would not disappear with an inheritance tax and would resurface in that alternative tax system. Additionally, in an inheritance tax regime, fractional interest discounts would proliferate. With any of the recent proposals, which are offered as substitutes for the present transfer tax system, property values would still need to reflect fair market value accurately, and in any system, including the current transfer tax system, valuation reform would need to occur.

In 2009, Professor Lily Batchelder made an innovative proposal to create a comprehensive inheritance tax (CIT) to replace the current transfer tax system and to tax large

---

16 See, e.g., Iowa Code Ann. § 450.3 (Listing as property included, under 7.a, Iowa references the federal QTIP marital deduction section 2056(b)(7)).
17 Id. (Listing as property included, under 2, Iowa cites both to the exclusions “under section 2503, subsections (b) and (e) of the Internal Revenue Code” and to gift splitting as allowed “in section 2513 of the Internal Revenue Code.” Id.).
19 See Part V, infra.
20 See 2008 Joint Committee print, supra note 8, at 22.
22 See 2008 Joint Committee Print, supra note 8, at 22, citing Joint Committee on Taxation, Options to Improve Tax Compliance and Reform Tax Expenditures (JCS-02-05), at 396-404, Jan. 27, 2005 (proposing rules that would limit the use of minority and marketability discounts under the present U.S. estate and gift tax system).
gifts and bequests as income.\textsuperscript{23} She incorporates from existing inheritance tax systems the focus on the recipient of a gift or bequest because, as her data shows,\textsuperscript{24} the burden of the estate tax falls mainly on the beneficiary.\textsuperscript{25} According to her, approximately one-fifth of the recipients bear a disproportionate weight under the current transfer tax.\textsuperscript{26}

Professor Batchelder correctly points to the inequity between the wealthy and some less wealthy beneficiaries;\textsuperscript{27} however, her numbers do not explain to what extent this onus is the result of the decedent’s design, the applicable apportionment statute, or is the consequence of a lack of progressivity in our current flat transfer tax rate or an estate planning technique. Primarily, it is the decedent who controls the assignment of any tax and debt burden among his beneficiaries. Those costs may be assigned equitably or unevenly distributed among heirs and a decedent with two children, for example, can shift the tax burden to his wealthier child. Even

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{23} Batchelder, supra note 5. The CIT is a proposed replacement for the current transfer tax system that is integrated into the current income tax system and has features of a cumulative accessions tax. Each recipient of gifts and inheritances exceeding $1.9 million (plus $13k annual gifts and $65,000 in annual bequests) must include those amounts in income at the beneficiary’s tax bracket plus an additional 5-percent surtax. Bequests, like gifts currently, would receive a carryover basis. \textit{Id.} at 62-64. Professor Batchelder outlined a detailed explanation of the CIT tax treatment of a multitude of assets and transfers. My discussion of the CIT is highly abbreviated, but I have included a discussion of the CIT as the sole proposed, rather than actual, inheritance tax in this article because of its significant addition to the scholarship on this topic. \textit{See} 2008 Joint Committee print, \textit{supra} note 8, at 14.
\item \textsuperscript{24} Batchelder, supra note 5, at 4 (“In addition, none has maintained that wealth transfer taxes predominantly burden heirs, or provided estimates of the distributional effects of wealth transfer taxes at an heir level.” (citation omitted)
\item \textsuperscript{25} However, the actual beneficiary with the burden of taxation depends on whom the decedent places that burden in his will or in trust documents. Without a clear directive from the decedent, federal statutory presumptions, like those in sections 2205, 2206, 2207, 2207A, and 2207B, apply or state apportionment rules control. That is, in fact, only one heir (under a burden of the residue testamentary provision or state fallback rule) may have that burden despite other heirs being recipients of taxable estate assets.
\item \textsuperscript{26} \textit{Id.} at 3 (“Surachai Khitatrakun and I estimate that about 22\% of heirs burdened by the U.S. estate tax have inherited less than $500,000, while 21\% of heirs who inherit more than $2,500,000 bear no estate tax burden. . . .” \textit{Id.}); 2008 Hearings, \textit{supra} note 1, at 32 (Statement of Lily Batchelder) (“As Table 1 shows, in 2009 only about 5 in 1,000 people who receive an inheritance will bear any estate tax burden. In part, this is because more than 30 percent of heirs inheriting between $2.5 and $5 million are not burdened by the estate tax at all. Generally these heirs have inherited all or part of an estate just below the exemption threshold. Meanwhile about 4 percent of those inheriting between $500,000 and $1 million are burdened by the estate tax, often at quite high rates. Typically these heirs have inherited a much smaller amount from an even larger estate.”\textit{Id.}).
\item \textsuperscript{27} \textit{Id.} at 69 (“In aggregate, the distributional effects of the proposal are fairly similar to the estate tax system. As illustrated by Figures 15 and 16, the proposal is somewhat more progressive by economic income and inheritance size, but the differences are not dramatic. Heirs with economic income of less than $500,000 or inheritances below $2.5 million bear higher average tax rates under the estate tax. Meanwhile, those with economic income or inheritances exceeding these amounts bear higher burdens under the [CIT] proposal.”). \textit{See} Part III, \textit{infra}.
\end{itemize}
\end{footnotesize}
when understanding that an equal division may unfairly burden his poorer child, the decedent may still opt *not* to shift the tax burden or *not* to divide his property unevenly to offset this effect. The decedent may, for example, simply want to reward his more successful child who is more like himself. He may thus think that he is being fair: each child receives an equal amount. If that equal division results in one child shouldering more of the expense, that may be his choice.

If a decedent is silent or unclear on the issue of tax and debt burden apportionment in his will or trust instrument, there are Federal tax reimbursement statutes or state apportionment laws that control which beneficiaries must bear the expense, and that may be equitable (i.e., to the extent that the transferred property incurs a tax) or inequitable (like in burden-on-the-residue jurisdictions). Thus, the inequity she finds may at least to some extent be controlled by other federal tax statutes or by state law. Those laws are fallback provisions that come into effect when decedent does not specifically state which beneficiaries are to be saddled with the tax responsibility. Finally, where there are insufficient burdened assets to cover the decedent’s liabilities, the government will pursue its debt either from the executor or from *any* and all beneficiaries to the extent of the value of the property they receive from the estate.

Notably, by means of an irrevocable life insurance trust (ILIT), a common estate planning technique, the decedent can effectively finance the costs of estate taxes at a significant discount both to him and his family. That is, the proceeds of life insurance on decedent’s life are not included in the decedent’s estate when the policy is owned solely by the ILIT (and not

---


29 The executor must pay the taxes before distributing the property to beneficiaries or he may be responsible for that expense. See I.R.C. § 6901(a) and 31 U.S.C. § 3713(b). Pursuant to I.R.C. §§ 2204(a) and 6905(a), an executor can limit his liability by filing an application (Form 5495) after having filed the appropriate tax returns.

30 See I.R.C. §§6624(a) (2) and 6324(a) (2). Under those statutes, an individual beneficiary may be liable even for estate taxes relating to another beneficiary’s property up to the amount of property that individual has received from the estate.

31 See note 81, and accompanying text, infra.
transferred by the decedent to the ILIT within three years of his death) even if the decedent paid the insurance premiums. Yet, the untaxed proceeds can be used to provide additional funds and liquidity for his estate. So, in a sense and to some extent, often it is neither the decedent nor the beneficiaries that are burdened with paying a significant portion of the estate tax bill.32

An ILIT is often incorporated into an estate plan in second marriages where there is an age disparity between the spouses and where the older spouse has adult children from an earlier marriage who are similar in age to the younger spouse. When the older spouse dies, he may leave funds to those children through an ILIT.33 However, because the proceeds of an ILIT is not subject to estate tax, those bequests would not be a part of Professor Batchelder’s data.

Moreover, Professor Batchelder’s information may simply argue for re-instituting a more progressive rate structure into the current flat transfer tax rates.34 It is likely that the heirs most burdened are ones whose deceased parent or relative is at the margins of taxability in the current transfer tax system and not those heirs of the mega-rich who are each likely to be well off.

32 Id. Thus, Professor Batchelder’s statistics do not reflect how much of the 22 percent are so burdened because of the current transfer tax system and not because of other factors such as the decedent’s design or the effect of other laws; therefore, the inequity she finds may be less than her figures suggest.

33 See, e.g., Richard E. Barnes, Till Death Do Us Part (Again), 21 Prob. & Prop 34, 36 (2007) (“When appropriate, a large outright distribution, an irrevocable life insurance trust naming the children as beneficiaries, or a QTIP trust capped at a fraction of the estate may provide funds for the children immediately while still providing for the surviving spouse and lessening the animosity between the children and the younger spouse.” Id.).

34 See 2008 Hearings, supra note 1, at 3 (Statement of Lily Batchelder) (“Some people receiving relatively modest bequests may bear a substantial tax burden if they are inheriting from an extremely large estate, and some people receiving really extraordinarily large inheritances may bear no estate tax burden if they are receiving from one or more estates that are just below the lifetime exemption.” Id.). Professor Batchelder illustrates the tax burden disparity by comparing those estates below the exemption amount and therefore not taxed under the current transfer tax system with taxable estates wherein heirs received relatively small inheritances. Her point is well argued and supported though, as her data shows, reflects that the vast majority of recipients do not have this problem. Her data, moreover, does not consider the decedent's intentions, federal reimbursement statutes, and state apportionment law’s roles in placing the burden on the beneficiary. Likewise, the 22% figure might well be further reduced by the re-imposition of more progressive rates for those estates just over the exemption amount. See discussion and accompanying notes 35-37 and Part III, infra. With the increased exemption of $ 5.25 million, moreover, that figure for unfairly burdened heirs might already be substantially decreased. Id. Finally, more data needs to be collected about how many non-student adult heirs are in the lower income tax brackets.
Currently, there is a flat transfer tax rate of 40 percent in contrast the progressive rates in effect prior to the Tax Act of 2001 when they ranged from 37 to 55 percent. Especially with the current larger exemptions ($5.25M combined estate and gift tax exemption in 2013 compared to the $1M gift tax and the $3.5M aggregate transfer tax exemption in 2009 when Professor Batchelder published her CIT proposal), the skewed burden Professor Batchelder addresses more likely affects a smaller minority of heirs today. Also, those facts may point to a simpler solution than instituting a completely new tax like an inheritance tax or the CIT.

Some scholars, including Professor Batchelder, have argued on redistribution grounds that tax preferences should be given to decedents who pass property to less wealthy distant relatives or unrelated individuals. Indeed, the feature of the CIT that emphasizes the relationship between the transferor and the transferee is one that underlines its identity as a type of inheritance tax rather than as a pure income inclusion system. However, a tax preference for remotely related or unrelated recipients of decedent’s wealth does not and cannot equate with the

38 See Batchelder, supra note 5, at 69 (“In reality, the proposal would probably be even more progressive than the current system because these estimates assume no behavioral response. To the extent that donors respond to the incentives created by the proposal to give more widely and to those with less pre-inheritance income, pretax inheritances should become more progressive. As explained below, there is little, if any, evidence on which to base an estimate of this response. Id.”).
39 Anne L. Alstott, Equal Opportunity and Inheritance Taxation, 121 Harv. L. Rev. 469, 511 (2007) (“With these principles in place, we can now see that the equal opportunity perspective suggests a striking departure from the European inheritance tax model and from prior proposals for accessions taxation. Instead of taxing gifts and bequests from closer relatives at lower rates, the inheritance tax should tax bequests from relatives in full and should exempt those from nonrelatives.” Id.). However, Professor Alstott acknowledged that not only are those transfers unusual, but that they might encourage abuse (“Gifts and bequests from unrelated individuals are rare today, but the danger is that they might become the newest shelter for the rich.” Id. at 512).
goal of “breaking up large estates,” a purported objective of the transfer tax system. Decedents generally give their assets to a relatively few loved ones. Indeed, despite claims by those who expect that an inheritance tax would change a decedent’s behavior to increase the number of beneficiaries to whom a decedent would pass her property, there is some evidence that this perhaps logical result would not occur.

Finally and most haltingly, focusing on beneficiaries rather than on the decedent multiplies the number of taxpayers involved in reporting transactions that are inherently difficult to police. Our history with unreported tip income, where third parties are usually involved,

40 See, e.g., Wojciech Kopczuk, Economics of Estate Taxation: Review of Theory and Evidence, 63 Tax L. Rev. 139, 152 (2009) [Kopczuk] (“Suppose that high wealth concentration has a negative effect on the welfare of the society. If this is the case, then the targeting principle would call for a tax hitting wealth concentration. The current estate tax is precisely that kind of a tax: It affects only those with high wealth. Why might one think that wealth concentration is undesirable? For one thing, some of the world's worst-governed countries exhibit a high concentration of wealth. While correlation does not imply causality, it is at least consistent with the notion that a concentration of wealth, that is the situation in which some individuals are big relative to the state, has an adverse effect on the political process or constitutes a danger to democracy. This was one of the main arguments used when the estate tax was introduced in the United States.” Id.); Thomas Nagel, Liberal Democracy and Hereditary Inequality, 63 Tax L. Rev. 113 (2009)[Nagel] (“If contemporary fortunes are not whittled down by inheritance taxes and the donations to charity that such taxes encourage, we will find ourselves with a greatly enlarged long-term dynastic upper class of inordinate wealth. . . . A dynastic system that is allowed simply to float free of societal control is not merely a form of economic inequality, but a form of exemption of members of the privileged class from the minimal conditions of social solidarity.” Id. at 117-118); Gerald Jantscher, Aims of Death Taxation, in Death Taxes, and Family Property (Edward Halbach, ed. 1977), excerpted in Federal Taxation on Gratuitous Transfers, supra note 1, at 23-27. Besides a way to counter the concentration of economic and political power in the wealthiest individuals and families, the other stated rationales for taxing wealth transfers include revenue, equalizing opportunity, additional income tax progressivity, and a backstop to the income tax regime. See 2008 Joint Committee print, supra note 8, at 1-2. For arguments in favor of a high exemption to retain the positive attributes of family wealth, see Nagel, supra this note, at 120.

41 Kopczuk, supra note 40, at 151 (“Interpersonal externalities should not be ignored in a debate about transfers, but their relevance, in my view, is potentially important only when we are considering transfers throughout the distribution, rather than transfers at the top of the distribution, as is the case in the context of the current transfer taxation in the United States.” Id.). Despite having hundreds or even thousands of Facebook friends, most people have very few people they want to give or leave their property to and most are in the same socio-economic stratum as they are.

42 There is data that indicates that the wealthy do not take advantage of certain transfer tax benefits because of stronger motivational reasons such as fear of insufficient assets later in life or, more significantly, a desire to retain control over those who will likely be their ultimate beneficiaries. See text and accompanying notes 124-126, infra. It is also very unlikely that parents would no longer make most of their gifts and bequests to their children. See Kaplow, supra note 7, at 175 (“. . . most gifts are to relatives, the largest being from parents to children.” Id.). Perhaps genetic evolution theory may also support the proposition that such an upside down principle would never be enacted in the first place. See Seto, supra note 3.
should provide a warning of the difficulty of enforcement in the area of family gifts.\textsuperscript{43} Compliance rates would decrease significantly under an income inclusion or CIT system and administrative costs would increase.

The purpose of this article is to identify and critique common characteristics of the inheritance tax systems that exist in our U.S. states and internationally, particularly in Europe, using the current, albeit imperfect, federal transfer tax system as a benchmark. In addition, the article will examine the novel CIT proposal offered by Professor Batchelder that takes some elements of existing inheritance taxes as well as some features of the current transfer tax system and embeds them into the income tax system.

II. Existing Inheritance Tax Systems

A. Inter Vivos Transfers

Internationally, many inheritance taxes include some kind of taxation on gifts.\textsuperscript{44} For example, Germany, Ireland, Spain, and Finland subject gifts over an exemption amount either to a gift tax or to an inheritance tax.\textsuperscript{45} There are currently only six states in the U.S. with an inheritance tax\textsuperscript{46} and none of those states also imposes a state gift tax although five states with an inheritance tax also have a state estate tax\textsuperscript{47} and two states with an inheritance tax also have a state generation-skipping transfer (GST) tax.\textsuperscript{48} Some states with inheritance taxes include gifts


\textsuperscript{44} See 2008 Hearings, supra note 1, at 77 (Statement of Joseph Dodge) (“Finally, it is hard to integrate a gift tax with an inheritance tax.” \textit{Id.}). Most often, an inheritance tax is an annual tax on gratuitous receipts. See 2008 Joint Committee Print, supra note 8, at 7, n. 21.

\textsuperscript{45} \textit{Id.} at 8-9.

\textsuperscript{46} See note 10, supra.


\textsuperscript{48} See Iowa Code Ann. § 450A.2; Md. Code Ann., Tax-Gen. § 7-402 (imposed on GSTs that are not “direct skips” under I.R.C. § 2612 where original transferor was a Maryland resident on the date of the original transfer or, where a non-Maryland resident at that date, if the property has a situs in Maryland); former Ind. Code § 6-4.1-11.5-7, repealed for decedents dying on or after January 1, 2013. According to Hines, the CIT does not include transfers...
transferred within a specified number of years before the decedent’s death in their inheritance tax base.\textsuperscript{49} To the extent that an inheritance tax does not include all lifetime gifts, however, that inheritance system allows the very wealthy to avoid the tax since it is the wealthiest of individuals who can most afford to make early in life large transfers to their loved ones.\textsuperscript{50}

Some transfers that are generally not subject to an inheritance tax are those \textit{inter vivos} gifts wherein the donor has retained control over those assets until her death.\textsuperscript{51} The federal estate
currently subject to the federal generation-skipping tax. See James R. Hines, Jr., \textit{Taxing Inheritances, Taxing Estates}, 63 Tax L. Rev. 189, 202 (2009) [Hines]. Indeed, it is unclear whether Professor Batchelder would keep a GST tax in the CIT. She states, \textquoteleft\textquoteleft To the extent that the current tax treatment of accrued gains, generation-skipping transfers, income in respect of a decedent, illiquid assets, charitable contributions, and gifts made during life for education and medical expenses are considered desirable or politically necessary, these exemptions could be maintained.\textquoteright\textquoteright Id. at 65 (emphasis added). However, Professor Batchelder proposed that the CIT have its own type of GST tax with its incidence on the ultimate beneficiary. See Batchelder, \textit{supra} note 5, at 66-67 (\textquoteleft\textquoteleft Finally, the proposal would tax transfers to grandchildren (and more distant lineal descendants) as if the amount inherited had first passed first to their parents (and any additional skipped generations), and only then to the actual heirs. In practice, this would be accomplished by applying an implicit tax to the skipped heir at the top tax rate, unless the recipient presented evidence of what the skipped heir would have owed if the funds had actually passed to them initially. This treatment should apply regardless of whether the transfer is made directly or through a trust.\textquoteright\textquoteright Id.) (Citation omitted).

\textsuperscript{49} Iowa does not have a gift tax, but most gifts made within three years of death are included in the state’s inheritance tax. Iowa Code Ann. § 450.3. Likewise, Kentucky’s inheritance tax includes gifts made within three years of decedent’s death unless shown not made in contemplation of his death. Whether a transfer made more than three years prior to decedent’s death was made in contemplation of death is a factual question determined by “the proper tribunal.” Ky. Rev. Stat. Ann. § 140.020. See KY Inheritance Guide, \textit{supra} note 12, at 9. Maryland’s inheritance tax includes gifts intended to take effect in possession or enjoyment at or after the decedent’s death, gifts in contemplation of death, and transfers within two years of death even if not in contemplation of death. Md. Code Ann., Tax-Gen. § 7-201(d) (1). Nebraska subjects transfers within three years of death where a federal gift tax return must be filed. Neb. Rev. St. § 77-2002(2) while Pennsylvania’s inheritance tax taxes transfers within one year of death as long as that transfer in the aggregate exceeds $3,000 in any calendar year. 72 Pa. Stat. Cons. § 9107(c) (3). When the federal estate and gift tax systems became unified under one rate system and credit in 1976 (although the taxes were not unified between 2002 and 2010), there was no longer any need for most transfers made within three years of death to be subject to federal estate tax. See Federal Taxation on Gratuitous Transfers \textit{supra} note 1, at 33-34 (\textquoteleft\textquoteleft The transfer-in-contemplation-of-death provision has been greatly watered down. What’s left of it is located in §§2035. The ‘testamentary effect’ idea has undergone gradual evolution over the years, and has been dispersed over Code §§2036-2039. Thus, the following nonprobate items attributable to inter vivos transfers are currently included in the gross estate: (1) the proceeds of insurance on the decedent’s life where the insured owned the policy and made a gift of it within three years of death (§2035(a)); (2) gift tax paid (or owed) on gifts made within three years of death (§2035(b)); . . . .\textquoteright\textquoteright Id.). However, unlike federal law that subjects transfers of certain retained powers or interests made within three years of death under §2035(a)(2), New Jersey’s inheritance tax exempts such transfers from its inheritance tax. N.J. Stat. Ann. § 54:34-1.1: gifts of retained rights or powers made more than three years of death are deemed not make in contemplation of death. Id.

\textsuperscript{50} See Margaret Collins, \textit{Rich Passing Up $10 Million Opportunity to Gift Tax-Free}, Bloomberg (Jul 13, 2012), available at: \url{http://www.bloomberg.com/news/2012-07-13/rich-passing-up-10-million-opportunity-to-gift-tax-free.html} (“For families with more than $100 million, deciding to transfer as much as $10 million now may be an easier decision because it’s a much smaller percentage of their net worth. . . .”).

\textsuperscript{51} Iowa also includes property either subject to a general power of appointment held by the decedent at his death or exercised or released within three years wherein if decedent had owned the property outright would have been
tax insures that those types of lifetime transfers are included in the decedent’s taxable estate.\textsuperscript{52}

By means of the estate tax, if a decedent makes a gift but retains either a life interest in that property\textsuperscript{53} or a power to control the lifetime possession or enjoyment of that property,\textsuperscript{54} the full date of death value of that property will be included in his estate.\textsuperscript{55}

Early case law described these types of transfers with lifetime retained control or a lifetime retained property interest as “will substitutes.”\textsuperscript{56} Congress quickly reacted to three Supreme Court cases\textsuperscript{57} that had allowed decedents to avoid estate taxes for gifts with respect to

---

\textsuperscript{52} See I.R.C. §§ 2036 & 2038. I.R.C. § 2035 includes the date of death value of such property transfers where the decedent transfers her retained interest or power within three years of her death.

\textsuperscript{53} I.R.C. § 2036(a) (1). Section 2036 applies to transfers wherein decedent retains either the income from income producing property or the present enjoyment of non-income producing property for her life, for any period not ascertainable without reference to her death, or for any period that does not end before her death.

\textsuperscript{54} I.R.C. § 2036(a) (2). Section 2038 applies also to such powers although application of this section requires inclusion of only the value of the income interest remaining at decedent’s death as calculated under the actuarial tables. Thus, there is some overlap between these two Code sections.

\textsuperscript{55} I.R.C. § 2036. However, where the property itself, and not the income interest, is subject to a retained power, only the value of the remainder interest at decedent’s date of death is included in his estate. I.R.C. § 2038. Reg. § 20.2038-1(a).

\textsuperscript{56} See, e.g., Helvering v. Hallock, 308 U.S. 106, 114 (1940).

\textsuperscript{57} The three per curiam decisions are Burnet v. Northern Trust Co, 283 U.S. 782 (1931); Morsman v. Burnet, 283 U.S. 783 (1931); McCormick v. Burnet, 283 U.S. 784 (1931).
which they had retained a lifetime right to enjoy the transferred property. That statute, substantially the same as the current one, was enacted to prevent tax avoidance. Congress refused to allow fundamentally testamentary lifetime gifts to evade estate tax. Ironically, state inheritance taxes were the source of the phrase “possession or enjoyment” of property in the federal estate tax statute, but, with the exception of Pennsylvania, either states have eliminated their inheritance tax or have restricted inclusion of lifetime transfers to those occurring within a limited time, such as within a year or within a few years of decedent’s death.

Because inter vivos transfers with retained donor control focuses on the donor-decedent to determine when a gift is complete, it would seem that the current transfer tax system provides a more suitable means to prevent this type of abuse. While imperfect, the federal transfer taxes are more comprehensive, and hence more equitable, than most inheritance tax systems.

58 See Comm’r v. Est. of Church, 335 U.S. at 639-640 (“Both houses of Congress unanimously passed and the President signed the requested resolution that same day.” 335 U.S. at 640); United States v. Byrum, 408 U.S. 125, 160, 165 (1972) (J. White, dissenting).
59 See Comm’r v. Est. of Church, 335 U.S. at 639-640 (Acting Secretary of the Treasury Ogden Mills stated that without Congressional action to reverse the three Supreme Court opinions the resulting loss to the Treasury would be “in excess of one-third of the revenue derived from the Federal estate tax, with anticipated refunds in excess of $25,000,000.”); U. S. v. Byrum, 408 U.S. at 159-160 (J. White, dissenting). The dialogue between the following Congressmen underscores this intent: “Mr. Hawley. Mr. Speaker and gentlemen, the Supreme Court yesterday handed down a decision to the effect that if a person creates a trust of his property and provides that, during his lifetime, he shall enjoy the benefits of it, and when it is distributed after his death it goes to his heirs—the Supreme Court held that it goes to his heirs free of any estate tax. . . . Mr. Schafer of Wisconsin. This is a bill to tax the rich man. I shall not object. . . . Mr. Sabbath. Reserving the right to object, all the resolution purports to do is to place a tax on these trusts that have been in vogue for the last few years for the purpose of evading the inheritance tax on the part of some of these rich estates? Mr. Hawley. It provides that hereafter no such method shall be used to evade the tax. Mr. Sabbath. That is good legislation.” 74 Cong. Rec. 7198, cited in U. S. v. Byrum, 408 U.S. at 160 (J. White, dissenting).
60 See Comm’r v. Est. of Church, 335 U.S. 632, 646 (1949) (“Testamentary dispositions of an inter vivos nature cannot escape the force of this section by hiding behind legal niceties contained in devices and forms created by conveyancers.”).
61 Id. at 637-638 (1949) (“The ‘possession or enjoyment’ provision appearing in section 811(c) seems to have originated in a Pennsylvania inheritance tax law in 1826 . . . . Most of the states have included the Pennsylvania-originated ‘possession or enjoyment’ clause in death tax statutes, and with what appears to be complete unanimity, they have up to this day . . . substantially agreed with this 1884 Pennsylvania Supreme Court interpretation.”).
62 See, e.g., text and accompanying notes 10, 11, and 49, supra.
63 Section 2036, for example, should be amended to clarify that donor retained corporate fiduciary powers, like donor retained trustee powers, are subject to the statute. See Federal Taxation on Gratuitous Transfers, supra note 1,
B. Rates

A major tenet central to most inheritance taxes is the relevance of the decedent’s blood or adopted relation to the beneficiary. Many countries and individual U.S. states allow preferred rates, or zero rates, for lineal descendants of the decedent. In those instances, there is much less revenue generated from the tax as most decedents pass property to their children and

at 393 (“The majority opinion on the §2036(a)(2) issue was based on the notion that the decedent’s power was an ‘administrative power’ on account of the fact that it related to trust investments, and then stated that administrative powers lay outside of §§2036(a)(2) and 2038, relying on a very early case (under a different statutory provision) that did not really come to grips with the issue, followed by the unsupported (and dubious) claim that estate planners had relied continuously on that case. Against the argument that the decedent effectively had retained the power to accumulate the trust income, the Court majority said that such power was constrained by a general fiduciary duty under corporate law. However, such a duty is as general as that which bounds the dispositive discretion of a trustee. The better argument would be that the Board of Directors, not the controlling shareholder, has control over dividend policy, and the Board would set dividend policy by considering the welfare of the corporation rather than according to the beneficial enjoyment of the trust.” Id. (citations omitted)).

2008 Joint Committee Print, supra note 8, at 18 (“Under most existing inheritance tax structures, a larger exemption and lower tax rate schedule is assigned to transfers to a surviving spouse, often followed by a smaller exemption and higher tax rate schedule for transfers to lineal descendants, followed by a yet smaller exemption and higher tax rate schedule for transfers to other relatives, followed by an even smaller exemption and higher tax rate schedule for other transfers. Consequently, in practice, the exemption levels and rate schedules favor retention of wealth within the nuclear family as opposed to a broad division of transferred wealth.” Id.). See, e.g., Iowa Code Ann. § 450.10 (West 2012) (lineal tax rate is 0%, siblings and son-in-laws and daughter-in-laws are subject to inheritance tax rates between 5-10%, and collaterals are taxed at rates between 10-15%); Ky. Rev. Stat. Ann. § 140.070 (West 2012) (lineal tax rate ranges from 2-10% and collateral tax rate ranges from 4-16%); Md. Code Ann., Tax-Gen. §§ 7-203(b)(2), 7-204 (West 2012) (lineal tax rate 0%, sibling tax rate 0%, collaterals tax rate 10%); Neb. Rev. St. §§ 77-2004, 77-2005, and 77-2006 (2012) (lineal and sibling tax rate 1% over $40,000 exemption, more remote relatives tax rate 13% over $15,000 exemption, collaterals tax rate 18% over $10,000 exemption); N.J. Stat. Ann. § 54:34-2 (West 2012) (siblings tax rate ranges from 11-16% depending upon amount of transfer; collateral tax rate is 15% for amounts up to 700k and 16% on amounts in excess of 700k); 72 PA. Cons. Stat. Ann. § 9116 (West 2012) (lineal tax rate 4.5%, sibling tax rate 12%, collaterals tax rate, 15%); 2008 Joint Committee Print, supra note 8, at 7-8 (“Under the German inheritance tax, for example, the spouse is exempt from tax on the first €307,000 ($471,429) received by gift or, subject to certain limitations, the first €563,000 ($864,542) received by bequest. Each child is exempt from tax on the first €205,000 ($314,798) received by gift. In the event of a transfer by bequest, this basic exemption amount is increased by an amount up to €52,000 ($79,823) depending on the age of the child. Stepchildren, grandchildren, great-grandchildren, and, in the case of a bequest, parents and grandparents, are exempt from tax on the first €51,200 ($78,595) received. Siblings, nieces, nephews, stepparents, sons-in-law, daughters-in-law, parents-in-law, divorced spouses, and, in the case of a gift, parents and grandparents, are exempt from tax on the first €10,300 ($15,811) received. All others are exempt from tax on the first €5,200 ($7,982) received.” Id.). Finland has three different rate schedules based on relationships to the transferor in its inheritance tax system and in its gift and inheritance regime, Spain likewise distinguishes tax brackets on a relationship basis, but also incorporates a tax surcharge that varies based on relationship criteria and by the recipients pre-receipt level of wealth. See id. at 8-9.

See id.

See, e.g., Iowa Code Ann. § 450.9 (“In computing the tax on the net estate, the entire amount of property, interest in property, and income passing to the surviving spouse, and parents, grandparents, great-grandparents, and other lineal ascendants, children including legally adopted children and biological children entitled to inherit under the laws of this state, stepchildren, and grandchildren, great-grandchildren, and other lineal descendants are exempt from tax.”); Ky. Rev. Stat. Ann § 140.080(1)(c); Md. Code Ann., Tax-Gen. § 7-203(b)(2); N.J. Stat. Ann. § 54:34-2(a)(2).
grandchildren.\textsuperscript{67} Thus, more distant blood or adopted relatives are subject to higher rates and non-relative beneficiaries are generally accorded the very highest rates.\textsuperscript{68} A few systems include step-relatives somewhere in a preferred rate structure.\textsuperscript{69}

Different rates based on relationships, however, make less sense than imposing different, progressive rates based on the varying total amounts passing either from the decedent or to the beneficiaries.\textsuperscript{70} While some states have progressive rates, those rates are usually applied after an exemption that is based on the familial relationship between the decedent and the beneficiary; alternatively, some states have separate progressive rate structures depending on that relationship.\textsuperscript{71} Since decedents leave property to their loved ones, it is usually only fortuitous

\textsuperscript{67} Kaplow, supra note 7, at 175.
\textsuperscript{68} See note 64, supra.
\textsuperscript{69} See, e.g., Iowa Code Ann. § 450.9; Ky. Rev. Stat. Ann. § 140.070(1); N.J. Stat. Ann. § 54:34-2.1. New Jersey also treats as a decedent-child relationships those mutually acknowledge relationships of at least 10 years duration, beginning at or prior to the child’s fifteenth birthday. Id. Although Indiana recently passed legislation to eliminate its inheritance tax, beginning (retroactively) to January 1, 2013, the Indiana provision had provided for stepchildren in its classification system. Ind. Code Ann. § 6-4.1-1-3(a) (3) (For decedents dying after June 30, 2004 and before January 1, 2013, Indiana defined as a Class A transferee, “A stepchild of the transferor, whether or not the stepchild is adopted by the transferor.” Id.)
\textsuperscript{70} Wealth distribution is logically affected by one’s personal situation. Thus, it would be both unreasonable and unkind to tell a decedent without children that he would lose a tax benefit because he passes his property to a collateral relative or unrelated friend; likewise, it would be both unreasonable and unkind to tell a decedent with a child that he would lose a tax benefit because he passes his property to that child. Taxing a wealthy decedent on property passing at death at either progressive or high rates depending upon the size of his estate, regardless of his beneficiaries, is a much more reasonable, compassionate, and equitable way to raise revenue and to support public programs.
\textsuperscript{71} See, e.g., Indiana’s recently repealed statute, former Ind. Code Ann. § 6-4.1-3-10 (b) illustrates the complexity of such an elaborate structure: (“With respect to a taxable transfer or transfers resulting from the death of a decedent who dies after December 31, 2011, the first two hundred fifty thousand dollars ($250,000) of property interests transferred to a Class A transferee under the taxable transfer or transfers is exempt from the inheritance tax.”), repealed effective January 1, 2013. However, a class B or class C beneficiary may exempt very little from the value decedent transferred to her. Ind. Code Ann. § 6-4.1-3-11, repealed effective January 1, 2013 (“The first five hundred dollars ($500) of property interests transferred to a Class B transferee under a taxable transfer or transfers is exempt from the inheritance tax.”); & (“The first one hundred dollars ($100) of property interests transferred to a Class C transferee under a taxable transfer or transfers is exempt from the inheritance tax.”). After applying the appropriate exemption amount, in Indiana, there is a progressive rate structure; however, those rates are also dependent on the decedent’s relationship with the beneficiary. Ind. Code Ann. § 6-4.1-5-1(b) & (c), repealed effective January 1, 2013. Class A beneficiaries are taxed from 1-10% marginal tax rates, with the 10% bracket rate applying to net transfers of over $1,500,000 (i.e., $92,250, plus 10% of net taxable value over $1,500,000); class B beneficiaries are taxed from 7-15% marginal tax rates with the 15% rate applying to transfers over $1,000,000 ($107,000, plus 15% of net taxable value over $1,000,000 Id.); class C beneficiaries are taxed from 10-20% marginal tax rates with the 20% rate applying to transfers over $1,000,000 ($145,000, plus 20% of net taxable value over $1,000,000. Id.).
circumstances that dictate whether those individuals are lineal descendants, more distant
relatives, or non-relations.72

C. Exemptions for Specific Types of Property

Some inheritance taxes exempt certain types of property, such as life insurance proceeds,
from taxation.73 However, omitting a class of bequests without an exceptional rationale is
inefficient and inequitable. As such, exemptions should be sparingly granted and only where
necessary to pursue another important policy goal. Yet, some inheritance taxes exempt various
types of property without a sufficient rationale.74 While the exemption for household goods may
make sense on simplicity grounds, especially if the total value is fairly insignificant, Germany’s
additional exemption for artwork, which is fairly complex (different exempt percentages based
on several factors, including extent publically available) and much more revenue costly, may be
more problematic. Moreover, exempting certain types of property from the tax may encourage

72 See Estate of Odle v. Ind. Dep’t of State Rev., Ind. State Tax Court (June 28, 2013), available at: 06281301tgf.pdf
at in.gov. Although the estate lost this case because according to the court, its claim “was not adequately
developed,” the estate wanted the court to treat the beneficiaries as Class A, rather than Class B or C beneficiaries,
which they literally were under the state’s inheritance statute, because the Indiana’s state constitution prohibited the
legislature to “grant any title of nobility, nor confer hereditary distinctions.” Ind. Const. art. 1, § 35. That is, the
estate claimed a constitutional violation of that article and section because the inheritance tax granted benefits to
individuals based solely on birth distinctions. In Odle, the decedent was a widower. He and his wife had no children.
The facts stated that this was the reason that he left his property “to several collateral relatives, including nephews,
great nieces, and great nephews.” This common reason for not passing property to one’s descendants inequitably,
unreasonably, and unkindly, resulted in a heavier tax burden.
73 See, e.g., Ky. Rev. Stat. Ann § 140.030(2) (“The proceeds of an insurance policy payable to a designated
beneficiary, including a testamentary or inter vivos trustee, other than the assured or his estate, shall be tax-free.”);
Md. Code Ann., Tax-Gen. § 7-203(d) (“The inheritance tax does not apply to the receipt of the proceeds of a life
insurance policy payable to any beneficiary other than the estate of the insured.”); N.J. Stat. Ann § 54:34-4(c), (f),
(g). Ireland also exempts some life insurance proceeds from its gift and inheritance taxes. See 2008 Joint Committee
print, supra note 8, at 8.
74 See, e.g., 2008 Joint Committee print, supra note 8, at 8 (“The German inheritance tax, for example, provides an
exemption for household goods, works of art, and certain other property.” Id.). Germany, which partially (65% or
85%) or fully exempts artworks from its inheritance tax base, allows the heir to remain the owner. The sliding scale
seems to depend on the significance of the artwork, the work must remain in Germany or the EU, must be made
available to the public to some extent, and the associated maintenance and preservation costs must exceed any
revenue produced. The 100% exemption also requires that the owner have owned the piece or collection for at least
20 years. Dr. Stephan Scherer, The Handling of Works of Art in German Inheritance Tax Law (Schilling, Zutt &
Anschutz, private clients, Oct. 1011), available at http://www.sza.de/fileadmin/fm-
dam/Mandanteninformationen/2011_Oct_N_Client_Information_German_Inheritance_Tax_Law.pdf. Although
difficult to value, omitting art provides a large loophole in any tax system.
tax avoidance. It allows the taxpayer to plan around such favoritism, which in turn may undermine other goals of the tax.\textsuperscript{75}

Life insurance on the decedent’s life is inherently testamentary, but some states, like Maryland, do not subject the proceeds to its inheritance tax, which in turn erodes the tax base and exaggerates inequalities.\textsuperscript{76} By contrast, two Code sections require the proceeds of life insurance on decedent’s life to be included in his estate for estate tax purposes.\textsuperscript{77} The first Code provision requires the inclusion of insurance proceeds on the decedent’s life where either the proceeds pass to the estate or the decedent owned any of the incidents of ownership (i.e., the economic benefits\textsuperscript{78}) of the policy at death,\textsuperscript{79} and the second requires inclusion if decedent transferred the insurance or relinquished an incident of ownership within three years of death.\textsuperscript{80} That said, since 1981, insurance proceeds in an irrevocable life insurance trust (ILIT) that holds all of the ownership incidents are exempt from estate tax under the plain language of the statutes.\textsuperscript{81} Thus, the current transfer tax should be amended to reverse that result.

\textsuperscript{75} For example, if life insurance proceeds are exempt in an inheritance tax system favoring lineal descendants, an estate planner might well suggest that a client with a collateral beneficiary name that collateral as an insurance beneficiary and pass non-exempt property to tax favored relationship beneficiaries.

\textsuperscript{76} Originally, life insurance proceeds were not included in a decedent’s estate. It was not until 1918 that, motivated by the insurance companies’ advocating additional purchases of life insurance in order to evade the new estate tax, Congress specifically added insurance as subject to the tax. Stanley S. Surrey, Paul R. McDaniel, Harry L. Gutman, Federal Wealth Transfer Taxation 524-525 (Foundation Press 1987); See Federal Taxation on Gratuitous Transfers, supra note 1, at 240.

\textsuperscript{77} I.R.C. §§ 2042; 2035(a). Section 2042 replaced section 811(g) of the 1939 Code. In addition, insurance owned by the decedent on another’s life is included in the estate under I.R.C. § 2033 at its fair market value at decedent’s date of death (generally at the interpolated terminal reserve value). See Reg. § 20.2031-8.

\textsuperscript{78} Reg. § 20.2042-1(c) (2). Incidents of ownership are defined broadly in the regulations to include the economic benefits of the policy and include such powers as the ability to change the policy’s beneficiary or to obtain a loan against its cash surrender value. Incidents of ownership also includes a more than \textit{de minimis} (greater than “five percent of the value of the policy immediately before the death of the decedent.” The value of a reversionary interest is determined by utilizing the traditional methods of valuation like the actuarial tables. I.R.C. § 2042(2). When decedent is found to hold any of the incidents of ownership on insurance on his own life, the entire proceeds are includible in his gross estate. Reg. § 20.2042-1(a) (3).

\textsuperscript{79} I.R.C. §§ 2042 (1) & (2).

\textsuperscript{80} I.R.C. §2035(a).

\textsuperscript{81} Between 1942 and 1954, section 2042 required estate tax inclusion of life insurance on the decedent’s life either because the decedent owned the incidents of ownership in the policy or the decedent paid the insurance premiums. However, in 1954, the premium payment test was abandoned in order to allow the decedent to avoid estate tax
D. Transfers to Charity

In probably all tax systems, gifts to charities are fully or partially exempt from taxation. The benefits of the current transfer tax system include encouraging charitable gifts, both directly and indirectly. Some have pointed to the effect of charitable donations on the redistributive goal of the current transfer taxes. However, split interest gifts that provide benefits for both charitable and non-charitable beneficiaries have been, and continue to be, the source of abuse in the estate tax area. A major strength of an inheritance tax is that, with a split-interest trust, it would tax the non-charitable beneficiaries when their interests become possessory. This preferable tax treatment contrasts to the current transfer tax treatment of split interest trusts that requires the use of the actuarial tables to value both the amount of the charitable deduction and the non-charitable beneficiaries’ interest at the time the property is transferred to the newly


\[
\text{See Federal Taxation on Gratuitous Transfers, supra note 1, at 240-241. Moreover, the payment of premiums within three years of death no longer affects inclusion of the proceeds under §2035(a) because the “beamed transfer” of premium payments was eliminated as a basis for inclusion under that Code section in 1981. See Estate of Leder v. Comm’r, 89 T.C. 235 (1987), aff’d, 893 F.2d 237 (10th Cir.1989), acq. A.O.D. 1991-012 (Jul. 3, 1991); Estate of Headrick v. Comm’r, 918 F.2d 1263 (6th Cir,1990). Thus, the sole incidents of ownership test paved the way for the viability of irrevocable life insurance trusts (ILIT); that is, the current literal language of section 2042 provides a loophole for the decedent’s paid life insurance on his own life to escape estate taxation. See Headrick. There is not much criticism of ILITs; that may be not only because of the strong insurance lobby but also because ILITs provide liquidity for an estate, which in turn means a quick source of funds for estate tax payments, pleasing all parties including the government.}
\]

82 See, e.g., I.R.C. §§ 170 (income tax); 2522 (gift tax); 2055 (estate tax); Batchelder, supra note 5, at 81-82. Since charities are tax exempt under the income tax system, where a donor or a decedent transfers property to them, the recipient will have no taxable income. Id.

83 See, e.g., Kaplow, supra note 7, at 185 (“Suffice it to say for present purposes that charitable giving is significant and may be greatly influenced by transfer taxation. Effects can also arise indirectly. For example, some oppose repeal or significant reduction of transfer taxation because the subsidy for charitable giving via exemption would thereby be eliminated.” Id.);

84 See Aron-Dine, supra note 4, at 269 (“[T]here is evidence that the impact on charitable giving may be large. This is another issue worth bearing in mind in thinking about how wealth transfer taxes affect the distribution of resources in our society.” Id.).


formed, statutorily defined split-interest trust. It is the use of the actuarial tables to provide estimates of future value that is the source of this problem.\textsuperscript{87} 

E. Transfers to Spouse

Most inheritance tax systems allow unlimited transfers between spouses,\textsuperscript{88} which in some countries not recognizing same-sex marriages also include transfers between domestic partners.\textsuperscript{89} Though not necessarily supported by the couple as “one person” theory,\textsuperscript{90} since couples differ in their property sharing arrangements, there are other reasons for allowing this exemption.\textsuperscript{91} Although some relationships, especially those in a community property model, embrace the partnership theory of ownership for married couples,\textsuperscript{92} most exemptions for spousal transfers are better explained by the practical difficulties in tracing a couple’s property, which is often

\textsuperscript{87} Id. See Part IV, infra.

\textsuperscript{88} In 1981, Congress selected the marital unit as the unit of taxation for estate and gift taxes. The exemption is a deferral provision, requiring inclusion in the surviving spouse’s estate. The Economic Recovery Tax Act (ERTA) of 1981, Pub. L. No. 97-34, § 403(d) (1), 95 Stat. 172, 302 03 (1981). See, e.g., 72 Pa. Cons. Stat. § 9107(d) (“All succeeding interests which follow the interest of a surviving spouse in a trust or similar arrangement, to the extent specified in section 2113, are transfers subject to tax as if the surviving spouse were the transferor.”).

\textsuperscript{89} See 2008 Joint Committee print, supra note 8, at 8 (“In France, beginning August 22, 2007, inheritances between spouses and between unmarried individuals who live together and have entered into a partner contract are exempt from inheritance tax.” Id.).


\textsuperscript{91} Other justifications for the change to an unlimited marital deduction included the desire to remove problems involved in tracing of inter-spousal transfers, to aid married couples with more modest estates, and to simplify the administration of the provision. H.R. Rep. No. 201, 97th Cong., 1st Sess. 159 (1981); S. Rep. No. 144, 97th Cong., 1st Sess. 127 (1981); Joint Comm. on Tax'n, 97th Cong., 1st Sess., General Explanation of the Economic Recovery Tax Act of 1981, at 233 (“Under prior law, it was often extremely difficult to determine the ownership of property held within the marital unit and to determine whose funds were used to acquire that property.”); H.R. Rep. No. 201, 97th Cong., 1st Sess. 159 (1981); A.L.I. recommendations, supra note 90, at 354; Statement of Charles M. Walker, supra note 90, at 1187-88; H.R. Rep. No . 1380, 94th Cong., 2d Sess. 17 (1976).

\textsuperscript{92} The partnership theory of marriage is the basis for community property statutes. See Bea Ann Smith, Partnership Theory of Marriage: A Borrowed Solution Fails, 68 Tex. L. Rev. 689, 697 (1990) (“Recognizing the economic risk that divorce poses to women and to mothers, states adopted the partnership concept specifically to increase the distribution of property to women upon divorce and thus to offset the economic losses caused by divorce.”Id. (citation omitted)).
intermingled or continually exchanged. One commentator has suggested, however, that the marital deduction may be unnecessary with an income inclusion or CIT approach because of the income tax date of death benefit of a potential basis step-up accorded to property received from a decedent.

III. The Comprehensive Inheritance Tax (CIT) Proposal

In the CIT, Professor Batchelder proposes merging transfer taxes into the income tax system when gifts or bequests received by an individual aggregate to more than $1.9 million. After that threshold, the donee would have the excess subject to income tax inclusion at a 15-percent surtax above the donee’s income tax rate. Since each recipient has different economic means, Professor Batchelder concludes that taxing the donee more accurately reflects that person’s ability to pay; likewise she argues that the goal of imposing a 15-percent surtax on the highest income tax rate is to match the earned income rate, which would require including an additional tax to replicate the effect of the payroll tax. However, with respect to the estate tax, she contends that it is difficult to assess the incidence of tax.

Professor Batchelder criticizes the present transfer tax system as taxing inherited wealth less than earned income. She states that “Inherited wealth is currently taxed at one-fourth the rate of earned income due to high estate tax exemptions and the exclusion of inheritances from the

---

93 See note 91, supra.
94 See I.R.C. § 1014. Note, however, that the statute defines basis as fair market value at decedent’s date of death or, if elected, the alternate valuation date. Although most property appreciates and thus one speaks of a step-up in basis, when property loses value, the Code section requires a step-down in basis, which is disadvantageous to the recipient of the property.
96 Batchelder, supra note 5, at 2; 2008 Hearings, supra note 1, at 3 (Statement of Lily Batchelder)(“So in effect, extraordinary inheritances would then be taxed at the same rate that earned income is now taxed under the income and payroll tax.” Id.).
97 Id. at 6; 2008 Hearings, supra note 1, at 3 (Statement of Lily Batchelder)(“In my view, its biggest weakness is that this relationship between, on the one hand, the heir’s financial circumstances, and on the other hand, the estate tax burden, is relatively imprecise.” Id.).
income and payroll tax bases.”98 While the current transfer tax may well undertax wealth, any inheritance tax advocating a high exemption level per recipient is open to that same criticism.99 While the surtax results in a higher burden for those receipts above her exemption amount, the same result could be more simply accomplished by raising estate and gift tax rates or lowering the exemption level. Moreover, the conversation cannot realistically be about wealth redistribution since only 22 percent of the recipients are not in the highest income tax bracket. For the majority of recipients, the CIT has no significant policy objective and may well decrease the taxation of wealth.100 Moreover, under the CIT, which advocates a $1.9M per donee exemption,101 family wealth concentration would persist.102

Some concerns about an inheritance tax with large exemptions, such as the C.I.T., are horizontal inequities,103 particularly where identical businesses pass to different sized families.104 Related to that issue is whether the estate tax provisions beneficial to family farms and small businesses can and would be incorporated into an inheritance tax.105

98 Id. at 1.
99 Professor Batchelder’s surtax affects only those gifts and bequests that in the aggregate exceed her exemption amount. See notes 22 and 96.
100 See notes 111-112 and accompanying text, infra.
102 See Kopczuk, supra note 40, at 139 (stating that “there are stronger arguments for estate taxation to be made based on externalities from wealth concentration.” Id.). In her indictment of the tax burden unfairly taxing heirs, Professor Batchelder does not view family wealth as a concentrated unit. Indeed, her proposal is intended to “allocate burdens much more fairly at an individual level.” Batchelder, supra note 5, at 69. Because her paradigm emphasizing the inequitable tax burden of heirs does not consider the unique relationship generally characteristic of closely related beneficiaries, Professor Batchelder does not attach value to family wealth remaining in the family. Nevertheless, coming from a different viewpoint, I think it would be helpful to know whether after the decedent dies and passes wealth to his children, whether those children at some later time make gifts to each other when a sibling or other close relative is in need. Likewise, it would be helpful to know whether and to what extent decedent passed disproportionate bequests either to aid a less wealthy sibling or to pass more wealth to a more sensible sibling so that, either formally (through a legal instrument) or informally (by precatory request or moral implication), that sibling can assist another sibling who cannot handle a large amount of money.
103 See, e.g., Hines, supra note 48, at 191.
104 See Udell, supra note 5, at 217 (“An inheritance tax, with a generous individual exemption can create significant horizontal equity distortions under these provisions for equal size businesses inherited by families of different sizes.” Id.).
105 Id.
Additionally, there are questions about whether inserting an inheritance tax into an income tax system, the payment vehicle for the CIT, is less a solution for recipient ability to pay issues than a full income inclusion approach with or without an additional, independent transfer tax system. Allowing a large exemption for gifts makes an inheritance tax like the CIT look more like the current estate and gift tax regime and less like the income tax system that is based on fairness and ability to pay goals. Special exclusions and large exemptions make sense in a wealth transfer tax system, particularly for consumption items and exempting all but the wealthy from the tax. Contrary to ensuring the goal of horizontal equity in the income tax system, those large exemptions are unique and offensive to the treatment of other types of income. Filtering the CIT through the income tax system, the CIT appears incongruent with much of the rest of the income tax provisions that are geared to ability to pay concepts. There is no other income tax provision that ignores a windfall of $1.9 million of income. Professor Batchelder’s criticism about the under-taxation of inherited wealth supports a full income inclusion approach for gifts

[106] Professor Batchelder justifies the CIT exemption on two grounds: “On the one hand, its exemption protects a basic level of familial economic support that one hopes all parents will provide so that each child has a reasonable opportunity to grow and flourish. On the other hand, by gradually taxing inherited wealth in excess of this amount, a comprehensive inheritance tax encourages extraordinarily wealthy donors to share further wealth transfers with individuals who have fewer opportunities than their children.” Batchelder, supra note 5, at 3. First, while a large exemption is sensible in a transfer tax, the income tax system currently provides for personal exemptions and the standard deduction in much more modest amounts that represent “a basic level of familial economic support.” Admittedly, those deductions pale in comparison to the $1.9M per person lifetime exemption. Secondly, as already theorized, people will continue to leave their property to those relatively few people they love; and wealthy people generally name their wealthy family members and friends as their beneficiaries. See notes 4-5, supra. It’s very difficult to believe that that pattern of giving would change. Those who want tax advantages already have the option of making charitable contributions to aid the poor; yet, most wealthy people contribute to their own charitable foundations, their favorite museum, or their alma maters. See Ken Stern, Why the Rich Don’t Give To Charity, The Atlantic (Mar. 20, 2013), available at: http://www.theatlantic.com/magazine/archive/2013/04/why-the-rich-dont-give/309254/.

[107] The income tax exclusion sections don’t aggregate to exceedingly large amounts of untaxed dollars. The de minimis fringe benefit, for example, underlines the income tax rejection of ignoring so large a benefit. See I.R.C. § 132(e); Income Tax Regs. §§ 1.132-6(d) (1) & (4), 1.132-6(e) (1). The only exception is, of course, the current exemption for gifts and bequests under I.R.C. § 102; however, that section is rationalized at least in part on the fact that we have a transfer tax system.
and inherited wealth. In contrast to the CIT, a full income inclusion system would be much simpler and more equitable.\textsuperscript{108}

In 2009, under the then current estate and gift tax system in effect when Professor Batchelder proposed the CIT, each donor could exempt a total of $1 million in aggregate gifts and a total of $3.5 million in total gifts and bequests.\textsuperscript{109} Also, generally wealth transfers are from parents to children.\textsuperscript{110} Thus, in 2009, the CIT would have produced additional revenue where a parent had one wealthy child, but a parent with two rich children would have received a total of $3.8 million, rather than $3.5 million, tax-free. A family with four children would have received $7.6 million, etc. tax-free.\textsuperscript{111} If, as I have suggested, wealth redistribution means greater tax revenue, which can be applied either to more spending or lower tax burdens for the less wealthy, there is likely to be less wealth redistribution with the CIT than with the current transfer tax system.\textsuperscript{112}

The CIT also imposes complexity with its disparate and somewhat unusual\textsuperscript{113} 15\% rate surcharge. Such additional taxes in the income tax context are generally the result of penalties; the CIT surcharge adds complexity and doesn’t fit well conceptually in that framework.\textsuperscript{114}

\textsuperscript{108} While more equitable, inclusion of gifts or bequests by focusing on the donees rather than the donor multiplies the practical difficulties of compliance. See text and accompanying notes 43, supra, and 118-120, infra.


\textsuperscript{110} See Kaplow, supra note 7, at 175 (“. . . most gifts are to relatives, the largest being from parents to children.” Id.).

\textsuperscript{111} Assuming a Congress in 2010-2012 willing to increase exemption levels, as history has proved, aggregate family wealth would likely also increase under the CIT proposal.

\textsuperscript{112} Likewise, as emphasized by Professor Hines, the CIT may lack a generation skipping transfer tax (GSTT), which in turn, as he points out, would result in more wealth concentration and lower tax revenue than the current transfer tax system. Hines, supra note 48, at 203-204 (“The logic of inheritance taxation suggests removing the tax on generation-skipping transfers as part of a broader package of transfer tax reforms, but such a reform might have the paradoxical effect of promoting greater wealth concentration than that which would materialize in the absence of any wealth transfer taxes.” Id.).

\textsuperscript{113} The unpopular bubble, subjecting estates between $10 million and $17.184 million to a 5\% federal surtax to the top rate of 55\%, effectively eliminated the benefits of the lower marginal rates applicable to the first $3 million of property in an estate and the $1 million exemption, until it was eliminated in the 2001 Act. The surtax was intended to create an overall 55\% rate for those estates by imposing the surtax and taxing those amounts at 60\%. See 2001 Act Explanation, supra note 36, at 57, 63-64; Aucutt, supra note 36, at 6.

\textsuperscript{114} See 2008 Hearings, supra note 1, at 77 (Statement of Joseph Dodge) (“An inheritance tax is basically like an estate and gift tax, but with a more complicated rate and exemption structure” Id.). Professor Udell is cautious about
2009, the income tax maximum bracket was 35% while the maximum transfer tax rate was 45%. Attaching a 15% surcharge to the 35% income tax rate would have subjected the excess to an additional 5% tax or to an income tax maximum rate of 50%. That additional 5% rate, however, might well recoup some of the shortfall that would be caused by the decedent’s leaving his wealth to more than one beneficiary.

Like many state inheritance taxes, and as noted by other commentators, the CIT is dependent upon many of the current transfer tax concepts and terminology. By merging the transfer tax language into the income tax system and by focusing on the transferee rather than on the transferor, the effect of the CIT is to increase complexity for a greater number of taxpayers. To the extent that the effect falls on lower income taxpayers, whom Professor Batchelder aims to assist, the CIT would increase their tax return preparation costs. Similarly, the CIT would increase the burdensome administrative duties and costs of more executors. By contrast, very wealthy individuals deal with complex financial issues routinely. Although some wealthy taxpayers may urge the need for simplicity, they generally seek simplicity only when it results in their paying lower taxes. While, for example, taxing wealth without any valuation discounting is

---

115 See Joulfaian, supra note 95, at 212 (“More importantly, the proposed inheritance tax would not replace the estate tax. Its starting point is the division of bequests reported on the estate tax return.” Id.); Batchelder, supra note 5, at 65; note 15, supra.

116 See notes 15-17, supra.
simpler, many wealthy taxpayers are fine creating complex transactions as long as the bottom line leaves them richer.\footnote{117} Moreover, the CIT is riddled with compliance issues.\footnote{118} Accounting for gifts in an income tax system would be much more difficult than with the current estate and gift tax system where all of the applicable decedents’ estates (currently less than 1\% of all estates) are examined and where delinquent gift tax returns are often filed at the decedent’s death. Auditing all income tax returns to discover non-compliance with gifts would be a mammoth, and probably impossible, task.\footnote{119} Finally, any inheritance tax is dependent upon gathering information about the decedent’s transfers. As stated by Joulfaian about the CIT, “It merely shifts the statutory

\footnote{117} See, e.g., Estate of Walton v. Comm’r, 115 T.C. 589 (2000), acq., Notice 2003-72, 2003-2 C.B. 964, (wherein the court invalidated then Example 5 of Reg. §25.2702-3(e), but also implicitly validated the taxpayer’s use of short-term two-year zeroed-out grantor retained annuity trusts (GRATs), avoiding gift tax while permitting the transfer of additional value to family members transfer tax-free); the popularity of family LLC’s and FLPs, by which the taxpayer reduces the value of liquid assets, typically from 30 to 70 percent, by transferring them to those family entities and then by transferring supposedly devalued entity interests to the younger members of the family, and of charitable lead annuity trusts (CLATs), by properly employing the actuarial tables to zero-out non-charitable family gifts. See Federal Taxation on Gratuitous Transfers, supra note 1, at 452, 460-461, §9.3.

\footnote{118} Kaplow, supra note 7, at 187, n. 1 (“Also, no attention is given to administrative concerns, especially pertaining to avoidance as well as the possibility that a transfer tax may in certain respects serve to backstop an income tax (although it can also reduce income tax receipts by heightening the benefits of schemes that reduce both taxes).” Id.); Louis Kaplow, A Framework for Assessing Estate and Gift Taxation, in Rethinking Estate and Gift Taxation 186-190 (William G. Gale, James R. Hines, Jr. & Joel Slemrod eds., The Brookings Institution 2001) [Rethinking Estate and Gift Taxation].

\footnote{119} Recall the checkered history and continual compliance issues of taxing waiters’ tip income in the restaurant industry, wherein third parties and business records are common characteristics (unlike with family gratuitous transfers). See http://www.irs.gov/Businesses/Food-Industry-Overview---Accounting-Principles,-Information-Systems,-&-Industry-Operating-Procedures (“Four tip reporting programs are available for these taxpayers to enter into with the Service. Two of these pro forma documents are titled Tip Reporting Alternative Commitment (TRAC) and Tip Rate Determination Agreements (TRDA). The IRS developed the Employer Designed Tip Reporting Alternative Commitment (EmTRAC) Agreement program in response to employers in the food and beverage industry who expressed an interest in designing their own TRAC programs. Attributed Tip Income Program (ATIP) is a new three-year pilot program for food and beverage employers. The first annual basis begins January 1, 2007. Details and requirements for participation for employers and employees are available in Revenue Procedure 2006-30. The agreements serve a dual purpose: improving compliance of tipped employees and avoiding tip examinations. The TRAC agreement is by far the more popular with large and midsized taxpayers. It can be obtained at: www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Voluntary-Compliance-Agreements---Restaurant-Tax-Tips” Id.; http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Reporting-Tip-Income---Restaurant-Tax-Tips : http://www.irs.gov/publications/p531/ar02.html .
incidence of the tax to the heirs while leaving in place all the existing complexities of deriving the size of the estate to be divided among the heirs.”

A simpler solution to deal with the inequities the CIT is intended to cure is to reinstitute a more progressive rate system into the current transfer tax system. Because of the large exemption and because the rate tables have remained the same, transfer tax rates have been a flat 45% rate between 2007 and 2009; a flat 35% rate between 2010 and 2012, and in 2013, a flat 40% rate. If the rates were changed to include multiple brackets so that those estates nearest to the exemption amount were, for example, taxed at a 35% rate and rates would progress to a top rate of 50%, the impact on less rich heirs would be reduced. This proposal is not equivalent to the impact of a CIT, which is intended to be better correlated with family size; however, it may correlate acceptably with lower income tax bracket beneficiaries.

The CIT is intended to provide an incentive for the rich “to share further wealth transfers with individuals who have fewer opportunities than their children.” Yet, it is unlikely that anyone, including the wealthy, would alter the recipients of their non-charitable gift-giving in a statistically significant way. Most taxpayers with children give their assets to those children and it is unlikely that that pattern would change despite the tax benefits the CIT would

---

120 Joulfaian, supra note 95, at 212.
121 See Federal Taxation on Gratuitous Transfers, supra note 1, at 32-33; 2012 Tax Act, supra note 35.
122 See Hines, supra note 48 at 190-191.
123 Batchelder, supra note 5, at 3. See Ann Mumford, From Dahomey to London to DC: Marketing Wealth with the Proposal for a Comprehensive Inheritance Tax, 63 Tax L. Rev. 221, 234 (2009) (citing this among other of the CIT’s positive responses to the negative death tax hype. “The comprehensive inheritance tax includes a clear response to death tax imagery by targeting the behavior of the donor before death.” Id.).
124 Former policy analyst Aron-Dine is also skeptical of that result. See Aron-Dine, supra note 4, at 266 (“Realistically, it does not seem to me that the proposal will lead wealthy decedents to split their estates into, say, $500,000 bequests to each of twenty needy, or even middle-income, people. Rather, what the proposal seems more likely to do is to encourage splitting large estates into $2 million bequests to a somewhat larger number of reasonably well-off people. “Id.).
125 See Kaplow, supra note 7, at 175.
promote. Moreover, there are more direct ways of encouraging that behavior such as raising
taxes on the wealthy that would provide additional revenue to subsidize the poor (or to relieve
the less wealthy of some of their tax burden). Likewise, the gift and estate tax charitable
deductions could be restricted to those programs of exempt organizations that predominantly aid
the poor (feeding, clothing, scholarships, subsidizing educational programs, etc.) or those
donations could receive increased tax benefits over the current limitations on the charitable
deduction.

Professor Batchelder intended for the CIT to correct the poor public image of the estate
tax as the “death tax,” a term coined in a successful campaign launched by opponents “who have
framed the estate tax as a double tax on frugal, hard-working donors who are ruthlessly taxed
right at the moment of death.” She intended the CIT to “improve public understanding of the
taxation of wealth transfers.” But, a new spin is always in the wings to combat reasoned
arguments. While the CIT focuses on the wealthy windfall recipients, it isn’t too much of a leap
to believe that CIT opponents would frame the CIT in similar terms: i.e., double taxation of those
hard-earned dollars passing from a caring parent to his grieving loved ones. Instituting a new
complex tax system is not the answer to powerful and contagious political rhetoric. Proponents
need to develop a more effective message or to create a better counter-spin.

Finally, one of the central reasons that make the present estate tax preferable to an
inheritance tax, including the CIT, is that the current transfer tax system deals well with _inter vivos_
transfers with retained powers. Professor Batchelder states that the CIT would likely rely

---

126 Richard Schmalbeck, Avoiding Federal Wealth Transfer Taxes 121-122, in Rethinking Estate and Gift Taxation, _supra_ note 118) [Schmalbeck] (persuasively concluding that even with the great tax benefit of the annual exclusion, few wealthy taxpayers currently are influenced to make those lifetime transfers because “the real barrier to full use of the annual exclusion is the strong preference of potential donors for the retention of economic power.” _Id._).
127 See, e.g., I.R.C. § 170(b) (percentage limitations) on the income tax charitable deduction for lifetime charitable
gifts.
128 Batchelder, _supra_ note 5, at 3.
129 _Id._
on the transfer tax definition of when a gift is complete. However, the gift completion rules differ in some important ways from the estate tax inclusion statutes so it is unclear what principle would apply. With current Code sections 2036 and 2038, there is a great deal of history with the estate tax grappling with abusive avoidance techniques involving retained control. Essentially, although they need reform, the current transfer taxes tax inherited wealth pretty well. There is a developed law determining what and when transfers should be taxed. While transfer tax reforms are needed, we’d have more avoidance and abuse with either an income inclusion method or the CIT than we have now. Since each donee has different economic means, those advocating an inheritance tax consider taxing the donee as more accurately reflecting ability to pay. However, because that integral part of an inheritance tax can also be subject to abuse, it has been suggested family attribution rules could be included in a CIT or any other inheritance tax to deal with that issue.

IV. Behavior

130 Id. at 65 (“Despite this fundamental change in the form of wealth transfer taxation, the proposal would continue to rely on much of the extensive body of laws, regulations, and guidance that have been developed under the U.S. estate tax system. For example, the existing rules governing when a transfer has occurred, how it is valued, and what transfers are taxable would remain unchanged. The proposal would not tax a large portion of wealth transfers, as under current law.”) (emphasis added)).

131 For example, the gift tax regulations consider a gift complete when the donor retains a power to determine when the beneficiary will receive the property (“the time or manner of enjoyment”), but the estate tax statute would include property subject to such powers in the decedent’s estate. See Reg. § 25.2511-2(d); Lober v. U.S., 346 U.S. 335 (1953). Likewise, the gift tax regulations incorporate the concept of a substantial adverse interest to allow a completed gift for joint powers despite the opposite estate tax rule stating that §2038(a)(2) applies to joint powers regardless of a co-holder’s substantial adverse interest. See Reg. § 25.2511-2(e); Helvering v. City Bank Farmers Trust Co., 296 U.S. 85 (1935).

132 See notes 51-62 and accompanying text, supra.

133 Kopczak, supra note 40, at 154-155. This author has suggested reforms on such abusive estate planning devices as family limited partnerships and charitable lead annuity trusts. See Wendy C. Gerzog, Valuation Discounting Techniques: Terms Gone Awry, 61 Tax Lawyer 775 (2008); Wendy C. Gerzog, Not all Defined Value Clauses Are Equal, 10 Pitt. Tax Rev. 1 (2012); Wendy C. Gerzog, The Times They Are Not A-Changin’: Reforming the Charitable Split Interest Rules (Again) [Reforming Charitable Split Interest Rules], 85 Chi.-Kent L. Rev 849 (2010); Wendy C. Gerzog, From the Greedy to the Needy, 87 Ore. L. Rev. 1133 (2009).

134 2008 Joint Committee print, supra note 8, at 19.

135 Udell, supra note 5, at 217 (“An inheritance tax, with a generous individual exemption can create significant horizontal equity distortions under these provisions for equal size businesses inherited by families of different sizes.”) Id.

Scholars have noted the lack of motive consistency with respect to gifts in the current transfer tax system and have found a “substantial variation in behavior among estate taxpayers.”\textsuperscript{137} They have found more estate planning where the decedent had a long illness before her death,\textsuperscript{138} but even the very old do not often opt to divest themselves of their holdings.\textsuperscript{139} The data “provides support for the notion that there are important barriers to tax avoidance, \textit{perhaps related to the undesirability of giving up control over assets}.”\textsuperscript{140} In general, however, avoidance behavior is not predictable because of the differences among those subject to the estate tax, both different behaviors among the wealthy in general and, specifically, at different points in their lives.

Particularly for the wealthiest of those subject to transfer taxes, taxpayers are more unwilling to devolve themselves of the control of assets than of their legal ownership.\textsuperscript{141} While making annual exclusion gifts is an easy way to reduce a decedent’s transfer tax liabilities, as Professor Schmalbeck has shown, the wealthy often do not make those gifts. “In the aggregate, it is estimated that, at most only about 15 percent of the value of the annual exclusion gifts that could be made tax free from potentially taxable estates are in fact made.”\textsuperscript{142} His explanations for this underutilization include “a work disincentive for young donees, retention of control over their children’s behavior and choices, and, for those close to the exemption amount, retention of sufficient assets to cover the taxpayer’s own medical or other unanticipated lifetime needs.”\textsuperscript{143}

\textsuperscript{137} Kopczuk, supra note 40, at 155.
\textsuperscript{138} Id. at 155-156.
\textsuperscript{139} Id. at 156, n. 79 (The “estates are growing with age even among the very elderly, further underscoring that avoidance is not always pursued in advance.” Id.).
\textsuperscript{140} Kopczuk, supra note 40, at 156 (emphasis added). This finding about behavior also underlines the importance of sections 2036 and 2038 and their role in preventing erosion of the estate tax.
\textsuperscript{141} Schmalbeck, supra note 126.
\textsuperscript{142} Id. at 121 (citation omitted).
\textsuperscript{143} Id.
That last motivation was particularly evident in the fall of 2012 when estate planners, anticipating a possible return to 2001 Act sunset levels or at least a reduction of the currently available high exemption amounts, were urging their clients to take advantage of the 2012 $5.12M per person aggregate transfer tax exemption. The motives Professor Schmalbeck described were coupled with the experience of the recent economic downturn where assets declined sharply in value. That combination made even the very wealthy taxpayers apprehensive that they would not have enough assets to sustain their desired standard of living.\textsuperscript{144} “Fewer than 10 percent of clients with at least $10 million have used even part of the exemption or plan to by December, said two-thirds of certified public accountants surveyed by the American Institute of CPAs.”\textsuperscript{145}

I agree with Professor Schmalbeck that much of what motivates behavior is that most estate planning under the current transfer tax system requires the donor’s relinquishing control of the transferred property and that the wealthy prefer not to do that.\textsuperscript{146} Again, that is why sections 2036 and 2038 are so important to retain and that is one reason, besides inherently greater administrative ease and higher compliance levels, for retaining both the focus on the donor or the decedent and the current transfer tax system.

\begin{footnotesize}
\footnotesize

\textsuperscript{145} Those figures were based on statistical information from 227 accountants, also financial planners. \textit{Id.} Another example of the wealthy’s being less sensitive to tax incentives is a poll dealing with charitable donations. Robert Frank, \textit{Why the Obama Tax Hikes Won’t Kill Charity}, WSJ Blogs (Mar. 4, 2009) (“B of A [Bank of America] and the Center on Philanthropy at Indiana University polled 700 households with net worths of at least $1 million and incomes of $200,000, which now counts as ‘Obama rich.’ . . . So only 10% of the rich would cut off their contributions—and that is only if deductions went to zero. President Obama is proposing to reduce the deduction for top-income households to 28% from 35 %.”), available at http://blogs.wsj.com/wealth/2009/03/04/why-the-obama-tax-hikes-wont-kill-charity/.

\textsuperscript{146} Kopczuk, \textit{supra} note 40, at 155.
\end{footnotesize}
A former policy analyst at the Center on Budget and Policy Priorities, Aron-Dine commented that an annual wealth tax would discourage savings more than a wealth transfer tax, imposed at the decedent’s death. She based that conclusion on the observation that “very rich people appear to accumulate wealth in large part because they want to be richer, rather than because they want to spend a lot of money or leave a lot of money to their children.”

Moreover, some of the wealthy do opt for estate tax avoidance or reduction planning. With respect to the CIT, Joulfaian stated, while currently the majority of the wealthy divide their assets equally, it is unclear whether they would continue to do so or whether they would change that pattern to create after-tax equal divisions; if the latter, he posited whether that would undermine the adoption of the CIT. Joulfaian also saw the potential for more bequests to foreign beneficiaries who would not be subject to the tax and that fractional interest discounts would increase. Thus, he concluded that the effect of the CIT would likely be to multiply “opportunities for tax avoidance and noncompliance.”

V. What a Federal Inheritance Tax Offers a Transfer Tax

The primary benefit of an inheritance system is its timing of taxation with receipt by the donee or beneficiary, thereby eliminating the current reliance on actuarial tables to determine

---

147 Aron-Dine, supra note 4, at 265, n. a1.
148 Id. at 268. Moreover, Aron-Dine stated that applying Professor Batchelder’s notion that transfer taxes should be a way of taxing nonmonetary advantages wealthy parents transfer to their children in the form of, for example, employment or educational opportunities, there is a greater correspondence between those benefits and decedent’s wealth than between those benefits and the monetary inheritance of each of decedent’s children. Id. at 267.
149 See Hines, supra note 48, at 191. (“As an empirical matter, even under estate taxation families generally divide their estates equally among surviving children.”).
150 Joulfaian, supra note 95, at 211. Joulfaian noted several behavioral changes in taxpayers’ reactions to the enactments of the GST tax and the unlimited marital deduction. Id. at 211-212.
151 Id. at 212.
152 Annuities and other partial interests in property, such as remainders, must be valued by the actuarial tables. I.R.C. §7520. Even before that statute’s enactment in 1988, Pub. L. 100-647, §5031(a), the regulations dealing with estate and gift tax valuation indicated their usage. See Reg. §20.2031-7(c), which indicates the applicable regulation and tables for valuing interests in decedent’s estate from before Jan. 1, 1952 to the present date, and I.R.C. §25.2512-7(c) for parallel valuation instructions for gift tax purposes. Their usage § 403 (a) (3) of the Revenue Act of 1918
the value of a split interest in property, such as a remainder interest. By matching the timing of the tax to the real transfer time, the tax consequences would accurately reflect the values of those gratuitous transfers. For example, the distortions and abuse of charitable split-interest trusts stem from the inherent flaws of valuing an interest by means of the actuarial tables at the time of the creation of the trust and not when the charity or non-charitable beneficiary actually receives the property.

The advantage of the actuarial tables is their simplicity and established acceptance. Yet, they do not and cannot reflect a real future value. No one has a crystal ball about future value and the assumptions in the tables are inherently flawed. The actuarial tables assume a fixed rate of growth based on current interest rates, which at any time but particularly when interest rates are low, are unlikely to be accurate in the long run. The tables rely on unreal assumptions like the supposition that today's interest rate is relevant to the eventual payout of a particular investment and they ignore the principal's actual growth during the term. Likewise, when an interest's duration is based on an individual's life instead of a term of years, the actuarial tables employ mortality assumptions that will often change during the term of the interest.

Most pointedly, moreover, it is the taxpayer who chooses if and when to use an estate planning technique that employs the actuarial tables. Thus, while the actuarial tables may be theoretically neutral, they are in fact only used when their valuation assumptions are very likely to be beneficial to the taxpayer.

---

153 See Batchelder, supra note 5, at 65 (“Rather than following the current approach, the proposal would apply an approach developed by William Andrews and wait to see who gets what before taxing transfers for which the taxable status of the beneficiary is unclear.”); 2008 Joint Committee print, supra note 8, at 21-24.

154 See Reforming Charitable Split Interest Rules, supra note 86, at 880-882.

155 See Federal Taxation on Gratuitous Transfers, supra note 1, at 114-116.

156 See 2008 Hearings, supra note 1, at 81 (Statement of Joseph Dodge) (“Actuarial tables are not only inaccurate in individual cases, but can be “gamed” by such devices as GRATs and private annuities.” Id.).
Thus, an inheritance tax system that taxes gratuitous transfers to a beneficiary on the actual receipt of the property does not need to rely on guesswork (i.e., the actuarial tables) and therefore minimizes gaming in this area. At the same time, the current transfer tax system could be reformed to curtail those abuses.\(^{157}\)

VI. Conclusion

Existing inheritance taxes inequitably tax the recipient based on the closeness of his relationship to the donor or decedent and many inheritance taxes lack the back up of a gift tax. Rewarding or punishing a relationship status between the transferor and transferee is not a good measure of ability to pay or an effective means of wealth redistribution. Moreover, eliminating lifetime gratuitous transfers favors the wealthiest of individuals who can best afford to make earlier in life transfers.

Most significantly, the flaw in instituting a federal inheritance tax is its multiplication of individuals subject to the tax. This escalation of returns would result in a lifetime of unreported cash and untracked property transfers among family members. Taking a lesson from the unreported tip income of restaurant employees, both from its history of abuse and complicated reporting requirements, a federal inheritance tax system would be virtually impossible to police, would increase administrative complexity and costs, and would be a debacle of such large proportions, that it would be even more hated than the current transfer tax system. It is difficult for the government to audit the one-time estate tax returns of a miniscule number of decedents;

\(^{157}\) See Reforming Charitable Split Interest Rules, supra note 86, at 880-882. While the goal of estate administration is to expeditiously settle the estate, the current transfer tax system already employs limited recapture rules and long term payment options that do not interfere with that aim. See, e.g., I.R.C. §§ 2032A (providing for recapture when during the ten years following decedent’s death, qualified heirs stop using the qualified real property for a qualified purpose like farming); 6166 (providing for the beneficial interest and estate tax installment payment rules that cover a 15-year period).
increasing the number of taxpayers subject to the tax would greatly magnify compliance problems.

Professor Batchelder’s CIT eliminates the disparity of burdens for some beneficiaries under the current transfer tax system. It also solves the problems of timing and valuation abuses that involve the actuarial tables. However, the CIT engenders its own problems: increased inequity (tax rates based on the lack of, or more distant, relationship between the donor or decedent and his beneficiary); increased family wealth concentration (families with more than one recipient would have an increased total exemption); increased valuation abuse (increased fractional interest discounts); increased recordkeeping costs (including those taxpayers who can’t know whether they will reach and exceed the exemption level at some time in the future); increased compliance problems (due to the increased numbers subject to the tax); and increased complexity (relying heavily on, but sometimes changing, the current transfer tax terminology and principles; the CIT’s rate surcharge; and its immersion into the federal income tax system).

Essentially, the transfer tax system works pretty well158 and has significant practical and theoretical advantages over a federal inheritance tax or CIT.

158 By means of its very large exemption (“applicable exclusion amount”), the transfer taxes collect revenue only from the property transfers of the very wealthiest of individuals. See What’s New - Estate and Gift Tax Form 706, available at: http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/What%27s-New---Estate-and-Gift-Tax; note 34, supra; 2008 Hearings, supra note 1, at 29, Figure 3 (Statement of Lily Batchelder) (“The estate tax system has been a small but stable source of revenue ever since the estate tax was enacted in 1916, generally raising between 1 and 2.5 percent of federal revenues as illustrated in Figure 3. . . In 2007, the estate tax system raised about 26 billion.” Id. at 29-30). In 2008, $24,870,000 was collected in estate taxes and $2,843,000, in gift taxes. Joint Committee on Taxation, Modeling the Federal Revenue Effects of Changes in Estate and Gift Taxation 15-16, Tables 3 & 4 (JCX-76-12), November 9, 2012, available at: https://www.jct.gov/publications.html?func=startdown&id=4492