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# THE INCOME EQUALITY CASE FOR ELIMINATING THE ESTATE TAX

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*The estate tax and income tax rules independently attempt to either promote or deter different behaviors. The interaction of these different rules often leads to disparate or unintended consequences to taxpayers: for example, achieving an overall lower effective tax rate by paying more estate tax to lower the income tax rate. This overlay of the estate tax rules on the income tax rules is a key problem at the core of our tax system. Yet, few scholars focus on this topic.*

*In this Article, I document the actual behavior of the trust and estate bar. By looking at how attorneys approach the intersection of estate and income taxes, I demonstrate deficiencies in the current scholarly belief, which is based largely on anecdotal information, that the wealthy have a preference for paying less or no estate tax. I show the real-world preferences that indicate wealthy taxpayers are paying high levels of estate tax to minimize the income tax incidents. After showing the shift of preferences and the resulting overall tax loss to the fisc, the Article then proposes useful policy solutions, such as elimination of the estate tax or using death as an income tax triggering event.*

## TABLE OF CONTENTS

INTRODUCTION .....	1144
I. HISTORY OF ESTATE TAX .....	1149

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A. UNDERPINNINGS OF THE ESTATE TAX .....	1150
1. Pre-1932 .....	1150
2. 1932–48.....	1151
3. 1948–76.....	1153
B. MODERN ESTATE TAX.....	1157
C. THE 1980 PHILOSOPHICAL SHIFT .....	1160
D. POST-MODERN ESTATE TAX .....	1166
II. RESPONSIVENESS TO ANOMALIES .....	1170
A. DOUBLE BASIS.....	1170
B. JEST TRUST.....	1174
C. SECTION 2038 TRUST.....	1175
III. MODERN WEALTH THEORY .....	1176
A. A PROGRESSIVE MARKETPLACE .....	1178
B. INCOME TAX EFFECT .....	1181
C. ASSET BLEND .....	1182
IV. ELIMINATE THE ESTATE TAX .....	1185
A. DUAL-INSTRUMENT APPROACH.....	1186
B. DEATH AS A REALIZATION EVENT .....	1188
C. ADDITIONAL ESTATE TAX ON APPRECIATION.....	1190
D. ADJUSTMENT OF RATES .....	1193
E. CARRYOVER BASIS .....	1195
CONCLUSION .....	1197

## INTRODUCTION

In the current election cycle, most American voters share two seemingly inconsistent preferences on taxation: eliminating tax deductions and loopholes for the very rich and eliminating the estate tax.<sup>1</sup> Why would voters favor taxing the rich more during life but not at all at death?<sup>2</sup>

Maybe these two policies are not as mutually exclusive as they first appear. This could be true if those who pay the estate tax pay less in income tax as a direct result. And indeed, the estate tax increases the basis (or cost) of the taxed asset. Because there is income tax minimization associated with the basis step-up under the modern estate tax for these wealthy individuals, in operation, the estate tax is actually compounding

1. Frank Newport, *Americans React to Presidential Candidates' Tax Proposals*, GALLUP NEWS (March 17, 2016), <http://www.gallup.com/poll/190067/americans-react-presidential-candidates-tax-proposals.aspx>.

2. See Bryce Covert, *What's More American than Inheriting a Fortune?*, N.Y. TIMES (Mar. 28, 2016), <https://www.nytimes.com/2016/03/28/opinion/campaign-stops/whats-more-american-than-inheriting-a-fortune.html>.

the concentration of wealth.<sup>3</sup> This means that eliminating the estate tax may actually raise the tax burden on the wealthy.

The harmonization of eliminating the estate tax with raising taxes on the income of the wealthy fits squarely with the beliefs of the more than 75 percent of the public who support reducing income inequality.<sup>4</sup> It is a cause that transcends party.<sup>5</sup>

Yet Americans apparently do not associate raising the estate tax with reducing inequality. In fact, polls consistently show that most Americans want to reduce or eliminate the “death tax.”<sup>6</sup> This is true even when the polling agency explains that the tax affects just 0.2% of estates.<sup>7</sup>

A range of theories have been proposed for why Americans hold to this belief, from marketing (for example, a rebranding from the estate tax to the death tax), to libertarian arguments that the tax “violates moral claims stemming from individual property rights,”<sup>8</sup> to a feeling that the estate tax is a double taxation, to the idea that we all believe we will be rich when we die. But no matter what the true source of Americans’ hostility to the estate tax may be, that hostility cannot be ignored. Instead, it can be harnessed to the cause of reducing income inequality by examining the combined effects of the estate and income taxes.

The redistributive properties of tax policy are a crucial tool for dealing with the income and wealth gaps.<sup>9</sup> The historic redistribution of concentrated wealth was the foundation of the estate tax. The pre-1980

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3. See, e.g., Victor Fleischer, *Taxing Founders’ Stock*, 59 UCLA L. REV. 60, 65 (2011) (finding that most of the Forbes 400 accumulated wealth through founders’ stock inherited with a stepped-up basis).

4. See Covert, *supra* note 2 (citing Richard Wike, *Inequality Is at the Top of the Agenda as Global Elites Gather in Davos*, PEW RES.: FACT TANK (Jan 21, 2015), <http://www.pewresearch.org/fact-tank/2015/01/21/inequality-is-at-top-of-the-agenda-as-global-elites-gather-in-davos>.)

5. *Id.*

6. *Id.*

7. *Id.* (citing Chye-Ching Huang and Chloe Cho, *Ten Facts You Should Know About the Federal Estate Tax*, CTR. ON BUDGET & POL’Y PRIORITIES (May 5, 2017), <https://www.cbpp.org/research/federal-tax/ten-facts-you-should-know-about-the-federal-estate-tax>).

8. Jennifer Bird-Pollan, *Death, Taxes, and Property (Rights): Nozick, Libertarianism, and the Estate Tax*, 66 ME. L. REV. 2, 3 (2013).

9. See Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 259, 274–75 (1983) [hereinafter Graetz, *Praise*]; Jerome Kurtz & Stanley S. Surrey, *Reform of Death and Gift Taxes: The 1969 Treasury Proposals, the Criticisms, and a Rebuttal*, 70 COLUM. L. REV. 1365, 1366–1367 (1970); Lawrence Zelenak, *Taxing Gains at Death*, 46 VAND. L. REV. 361 (1993); Eric M. Zolt, *Inequality in America: Challenges for Tax and Spending Policies*, 66 TAX L. REV. 641, 642 (2013). See generally Michael J. Graetz, *Taxation of Unrealized Gains at Death—An Evaluation of the Current Proposals*, 59 VA. L. REV. 830 (1973) [hereinafter Graetz, *Evaluation*].

estate tax served as an important backstop to the income tax.<sup>10</sup> The tax broke up the wealth taxpayers accumulated through tax-preferred income sources.<sup>11</sup> In contrast, the modern estate tax has in practice eliminated any estate tax burden for all but the top portion of the top 1 percent through a substantial increase in the exemption amount. The estate tax fails as a meaningful tool for wealth-busting for a number of reasons. But most importantly, it fails because of the tax planning and income tax minimization associated with the basis step-up under the modern estate tax for these wealthy individuals.<sup>12</sup>

Currently, most scholars advocate for keeping the estate tax, tying the need for its retention to the growing “Piketty” movement. Although this position may be theoretically salient, it is neither pragmatic nor tethered to political reality. This Article does not attempt to situate the impact of the estate tax in the larger income inequality movement, but engages in a practical thought experiment about what would happen if the estate tax were eliminated.

The modern incarnation of the estate tax is problematic. Its current flaws emerged with the 1980 reform and continued to expand with the American Taxpayer Relief Act of 2012 (“ATRA”).<sup>13</sup> The estate tax now exempts part of the top 1 percent. The creation of this new class of “working rich” started when the estate tax was made permanent in the ATRA, with a substantial increase in the exemption amount. The estate tax exemption amount was raised from \$1,000,000 to a \$5,000,000 indexed exemption amount for each taxpayer. Not only did the exemption rise, but the ATRA added a new portability aspect.<sup>14</sup> Portability ensured that planning was no longer needed for spouses to maximize the exemption amount. The predictable result of the change was a substantial reduction in

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10. Gerard M. Brannon, *Death Taxes in a Structure of Progressive Taxes*, 26 NAT'L TAX J. 451, 457 (1973); Harry L. Gutman, *Reforming Federal Wealth Transfer Taxes After ERTA*, 69 VA. L. REV. 1183, 1191 (1983) (citing *Federal Estate and Gift Tax: Hearings Before the H. Comm. on Ways and Means*, 94th Cong. 351 (1976) (statement of Robert Brandon, Public Citizen Tax Reform Research Group)); *id.* at 619 (statement of Gerard M. Brannon, Professor of Economics, Georgetown University); Kurtz & Surrey, *supra* note 9, at 1367. See also Louis Eisenstein, *The Rise and Decline of the Estate Tax*, 11 TAX L. REV. 223, 227–28 (1956) (discussing the early debates over the introduction of a federal estate tax and quoting Rep. Underwood, who in 1902 argued that “[t]he inheritance tax is levied on a class of wealth, a class of property, and a class of citizens that do not otherwise pay their fair share of the burdens of the Government”).

11. See Gutman, *supra* note 10, at 1191.

12. See, e.g., Fleischer, *supra* note 3, at 65.

13. See American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 101(c), 126 Stat. 2313, 2317–18 (codified as amended at I.R.C. §§ 2001, 2010–11, 2058).

14. See I.R.C. § 2010(c)(4) (2012).

the number of taxable estates and a corresponding decline in tax revenue.<sup>15</sup>

As a result of the ATRA, by 2013 only about 0.1%, or 1 out of 700 estates, owed any estate tax.<sup>16</sup> Under the ATRA, some 2,700 deaths raised about \$14 billion in estate taxes. This was much lower than the nearly \$38 billion that would have been raised under the old rules. The \$14 billion differential is the result of the increased exemption amount.<sup>17</sup> Furthermore, this measure of the tax impact does not take into account income tax effects of the basis step-up that resulted because of the estate tax increase.<sup>18</sup> Many commentators use the failure to derive revenue as a reason for eliminating the tax.<sup>19</sup> However, historically, the estate tax had the limited function of restraining excess accumulation of wealth, not raising additional revenue.<sup>20</sup>

Once it is evident that few estates pay tax, we can evaluate the problems posed by the basis step-up for all estates under \$10 million. This Article will highlight income tax problems that are under-explored in connection with the estate tax, especially the double-basis problem with community property income tax rules. From these foundations, it will become evident that taxpayers who normally would be considered rich are not paying estate tax. However, they are reaping tremendous rewards from the income tax rules that further separate the rich from the poor. For example, the Congressional Budget Office (“CBO”) estimates that the basis step-up will reduce income tax revenues by \$644 billion over 10 years.<sup>21</sup>

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15. See generally John A. Miller & Jeffrey A. Maine, *Wealth Transfer Planning for 2013 and Beyond*, 2013 B.Y.U. L. REV. 879 (2013) (discussing the intersection of the new ATRA rules with estate-planning techniques to highlight future efficiencies).

16. See CHYE-CHING HUANG & NATHANIEL FRENTZ, CTR. ON BUDGET & POLICY PRIORITIES, MYTHS AND REALITIES ABOUT THE ESTATE TAX 1 (2013), <https://www.scribd.com/document/185058815/Estate-Tax-Myths>; *Table T13-0019—Estate Tax Returns and Liability Under Current Law and Various Reform Proposals, 2011-2022*, TAX POL’Y CTR. (Jan. 9, 2013), <http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=377>.

17. See *Table T13-0019*, *supra* note 16.

18. The taxpayers that make-up this \$14 billion deficit fit within my definition of the “working rich.”

19. See generally, e.g., ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (2d ed. 2007) (advocating for eliminating the estate tax and replacing it with a flat tax); William G. Gale & Peter R. Orszag, *An Economic Assessment of Tax Policy in the Bush Administration, 2001-2004*, 45 B.C. L. REV. 1157 (2004) (discussing the distributive effects of tax cuts); David A. Weisbach, *Ironing Out the Flat Tax*, 52 STAN. L. REV. 599 (2000) (discussing the lack of tax raised by estate tax in the context of a flat tax); Zelenak, *supra* note 9 (discussing the failure to tax gains at death, resulting in annual revenue losses).

20. David J. Herzig, *Something from Nothing: Taxing Assets Accurately*, 2011 MICH. ST. L. REV. 1057, 1105 (2011) (citing *Tax Reform Act of 1975: Hearing Before the S. Comm. on Fin. on H.R. 10612*, 94th Cong. 22, 79 (1976) (statement of William E. Simon, Secretary of the Treasury)).

21. CONGRESSIONAL BUDGET OFFICE, *THE DISTRIBUTION OF MAJOR TAX EXPENDITURES IN THE INDIVIDUAL INCOME TAX SYSTEM* 16 (2013) (finding 21 percent of that subsidy goes to the top 1

This separation is the result of the asset composition of the lower wealth tiers—the government already provides subsidies through the income tax. There are exemptions from income tax, for example, for the sale of a home with less than a \$500,000 profit for a married couple. The lower wealth tiers, those least in need of income tax step-up, own the majority of assets that are already income tax exempt. Yet the wealthy taxpayers, who are most in need of income tax minimization because their asset composition is in non-exempt assets, are essentially receiving a free basis-step up. This double whammy of no estate tax plus basis step-up furthers not only the wealth separation but also the income separation.

If reducing wealth inequality is truly the goal, tax policies should acknowledge that the estate tax is actually expanding, not reducing, this separation. Elimination of the estate tax would certainly have some benefit to the super rich, but it would also hurt them from an income tax perspective, and their net tax burden should increase.<sup>22</sup> After all, how can a 25 percent blended capital gain rate be less than 40 percent of the ordinary income rate?<sup>23</sup> So how could this be true? The main problem with this common assumption is that there is a single dimension of estate tax and income tax interaction at the capital gains rates. However, this marginalizes the ordinary income tax effects related to the estate tax; for example, there is the depreciation recapture problem. With those assumptions, the proper comparison is that a 45 percent (40% + 1.2% + 3.8%) blended rate is higher than an income tax rate of 40 percent.

Although one does not normally think of progressives as advocating for the repeal of taxes, this Article provides one example by explaining why the elimination of the estate tax would actually be more effective at breaking up wealth than the current estate tax. The argument proceeds in four parts. Scholars familiar with the history of the estate tax and taxpayer responses to it may skip to Part III. Part I reviews a history of the estate tax

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percent of income earners); LAWRENCE H. SUMMERS & ED BALLS, CTR. FOR AM. PROGRESS, REPORT OF THE COMMISSION ON INCLUSIVE PROSPERITY 39 (2015), <https://cdn.americanprogress.org/wp-content/uploads/2015/01/IPC-PDF-full.pdf>.

22. The locked-in effect that the estate tax causes is certainly lessened just by enacting a carry-over basis regime. See, e.g., Nancy M. Annick, *Plugging the "Gaping Loophole" of the Step-Up in Basis at Death: A Proposal to Apply Carryover Basis to Excess Property*, 8 PITT. TAX REV. 75, 77–79 (2011); Gerald Auten & David Joulfaian, *Bequest Taxes and Capital Gains Realizations*, 81 J. PUB. ECON. 213, 226–227 (2001); Herzig, *supra* note 20, at 1063–72; Lily Kahng, *Path Dependence in Tax Subsidies for Home Sales*, 65 ALA. L. REV. 187, 229 (2013); Wilbur A. Steger & Frederick H. Rueter, *The Revenue Effects of Estate Tax Repeal and Basis Step-Up Limits*, 107 TAX NOTES 1314, 1315 (2005).

23. I used 25 percent because capital gains rates are 20% plus the 1.2% Pease surtax plus the 3.8% ACA surtax.

and the policy reasons for the tax. It explains how, in application, taxpayers are compounding the benefit of the estate tax through the community property rules. Part II then examines and classifies the various taxpayer behaviors that result from the application of the modern estate tax. Part III examines the various ways to measure wealth and how best to define not only the income gaps but also the asset allocation gaps. By looking at the asset blend of various wealth strata, it becomes evident how the estate tax is exacerbating the income consolidation at the top end in a manner which resonates with the public. Part IV then discusses the various alternatives and the potential responses to the proposal. The ultimate conclusion of the Article is that elimination of the estate tax is needed from a tax policy and fairness prospective.

### I. HISTORY OF ESTATE TAX

Throughout early American history, the estate tax was sporadically implemented in order to subsidize the fisc during times of war.<sup>24</sup> At the end of the controversy, the tax would be repealed. Once again as a wartime measure—to pay for World War I—Congress in 1916 enacted what was essentially the precursor to the modern estate tax.<sup>25</sup> However, unlike the prior forays using the estate tax to generate additional revenue to fund war, Congress did not revoke the tax after hostilities ended.

This was especially surprising since there was a budget surplus at the end of the war.<sup>26</sup> If there was a budget surplus at the end of the war and historically Congress had revoked wartime taxes, why in 1918 did Congress not terminate the tax? A significant narrative had changed in post-war America. Shaped by Teddy Roosevelt and Andrew Carnegie, the estate tax was not viewed as merely a source of revenue but as a tool to

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24. See Act to Provide Ways and Means to Meet War Expenditures, and for Other Purposes, ch. 448, § 29, 30 Stat. 448, 464-65 (1898), *repealed by* Act to Repeal War-Revenue Taxation, and for Other Purposes, ch. 500, 32 Stat. 96, 96 (1902); Act to Provide Internal Revenue to Support the Government and to Pay Interest on the Public Debt, ch. 119, § 110, 12 Stat. 432, 483 (1862), *modified by* Act to Provide Ways and Means for the Support of the Government, and for Other Purposes, ch. 172, § 1, 13 Stat. 218, 218 (1864), *and by* Act to Provide Internal Revenue to Support the Government, to Pay Interest on the Public Debt, and for Other Purposes, ch. 173, § 126, 13 Stat. 223, 285-91 (1864), *and repealed by* Act to Reduce Duties on Imports, and to Reduce Internal Taxes, and for Other Purposes, ch. 315, § 36, 17 Stat. 230, 256 (1872); Act Laying Duties on Stamped Vellum, Parchment and Paper, ch. 11, 1 Stat. 527 (1797), *repealed by* Act to Repeal the Internal Taxes, ch. 19, § 1, 2 Stat. 148, 148 (1802); Jeffery A. Cooper, *Ghosts of 1932: The Lost History of Estate and Gift Taxation*, 9 FLA. TAX REV. 875, 879 (2010).

25. See SIDNEY RATNER, *TAXATION AND DEMOCRACY IN AMERICA* 345-46 (photo. reprint 1980) (1967).

26. See Cooper, *supra* note 24, at 882.

reverse the concentration of wealth occurring during the first “Gilded Age.”<sup>27</sup>

The modern estate tax began as a tool of redistribution born of the Progressive movement occurring in America at the time.<sup>28</sup> The idea that the tax could serve as a meaningful consolidated-wealth buster is a narrative that would continue through future examinations of the tax. Then in 1980, however, a significant shift of priorities occurred, moving the tax from a progressive backstop to the income tax to a limited, optional tax on the top 1 percent of taxpayers. Since 1980, all changes have only continued to narrow the band of taxpayers subject to the estate tax.

#### A. UNDERPINNINGS OF THE ESTATE TAX

The historical estate tax existed during three main periods: pre-1932, 1932–48, and 1948–76, each with similar ideals and structure. The pre-1932 tax had its grounding in Progressive ideals and compromise. Examination of this important period helps to frame the current discussion of rationales for, and retention of, the estate tax. The middle period focuses on the unintended separations caused by state property law principles. The 1948–76 period focuses on the long stretch of relative quiet in both the challenge of the redistributive principles of the tax as well as the revenue effects. This period of the long history, leading up to seismic change in 1976, is especially important in the current second “Gilded Age” being examined today.

##### 1. Pre-1932

The pre-1932 period was really comprised of two sub-periods: first, the estate tax as a method to fund early American war, and second, a continuation of the tax after World War I as a progressive redistribution tool. It is the later period that is the more important. Historically, after short-term revenue needs were satisfied, both the income and estate taxes used to accomplish the goals were revoked.<sup>29</sup>

After the Armistice, Congress did not revoke the estate tax, although it

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27. *Id.*

28. *See id.* at 885–93.

29. David J. Herzig, *Marriage Pluralism: Taxing Marriage After Windsor*, 36 CARDOZO L. REV. 1, 16–20 (2014) [hereinafter Herzig, *Marriage*]; David J. Herzig, *Justice for All: Reimagining the Internal Revenue Service*, 33 VA. TAX REV. 1, 17 (2013); Stephanie Hunter McMahon, *A Law With a Life of Its Own: The Development of the Federal Income Tax Statutes Through World War I*, 7 PITT. TAX REV. 1, 13 (2009); Joseph J. Thorndike, *Reforming the Internal Revenue Service: A Comparative History*, 53 ADMIN. L. REV. 717, 737 (2001).

would have been a logical step as well as in keeping with past precedent. After all, in 1916, there had been a budget surplus, and it resumed soon after the war ended.<sup>30</sup> During this initial period, Congress responded to the end of the war by reducing rates slightly. It was not until the 1920s that it gave serious thought to the future of the tax. The first of the two sides to the debate were the Progressives who wanted to increase the top rate and buttress the estate tax with an income tax.<sup>31</sup> The other side, led by conservatives such as Andrew Mellon, wanted elimination of the tax.<sup>32</sup> Leading up to the 1932 revisions, both sides won the day at various times.<sup>33</sup>

Although there were early arguments over the retention and rates of the tax, the tax remained fundamentally unchanged until 1932. After the stock market crash of 1929 and the need for increased revenue and a balanced budget, however, it was ultimately decided to create a more robust estate tax, buttressed by a gift tax. Contemporary thinkers viewed the tax as a tool for income redistribution. Instead of serving solely a revenue-raising device, it was also viewed as a tool with which to break up wealth.<sup>34</sup>

## 2. 1932–48

During this middle period of the early tax, a version of the modern estate tax began to take shape. Instead of emerging out of war, the estate tax revisions in 1932 were born of economic necessity. As the country sank further and further into the Great Depression, Congress needed to make important decisions about how to balance the budget. Ultimately, it was decided that the estate and gift taxes would be key components of the budgetary process.

What we know as the modern estate tax thus began in 1932.<sup>35</sup> This version of the tax combined the reasons for enactment and tax design (e.g., rates, base, and gift taxes) that are still addressed today. In the events leading up to 1932, piggybacking on prior Progressive rhetoric, there was a backlash against the wealthy, who took much of the blame for the fall of the stock market and the resulting depression. Their speculative investment

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30. See *Table 1.1—Summary of Receipts, Outlays, and Surpluses or Deficits*, U.S. GOV'T PUB. OFF. (Feb. 9, 2016), <https://www.gpo.gov/fdsys/search/pagedetails.action?collectionCode=BUDGET&granuleId=BUDGET-2017-TAB-2-1&packageId=BUDGET-2017-TAB>.

31. Cooper, *supra* note 24, at 883.

32. *Id.*

33. *Id.* at 893–94.

34. Cooper, *supra* note 24, at 885–86.

35. Revenue Act of 1932, 72 Pub. L. No 154, 47 Stat. 169 (1932); Cooper, *supra* note 24, at 879.

schemes, implemented to allow income growth, but at unsustainable rates, were thought to be significant contributors to the crash.

Thus, in the Revenue Act of 1932 (“1932 Act”), the structure of the tax was not only to raise revenues, but also “ha[d] for its purpose the redistribution of a part of these tremendously large private fortunes.”<sup>36</sup> This redistribution and breaking up of concentrated capital was deemed necessary because wealth was “a menace to the security and continuation of American institutions.”<sup>37</sup> The progressive utility of the tax had been firmly entrenched, and by putting the money in the hands of the workers—through spending—the hope was that the economy would recover. The redistribution tool used was the tax system, taking a Keynesian approach on the use of estate tax and consumption:

Keynes came finally to the conclusion that inequality of inheritances stood on a lower basis of justification than inequality of income; in his opinion death duties calculated to promote a greater propensity to consume might very well promote the growth of capital because of the redistribution of wealth they effected.<sup>38</sup>

As with any new tax, the 1932 Act required significant design choices regarding the appropriate tax base and the amount of the tax. Tasked with both raising revenue and breaking up wealth concentrations, Congress had to do more than merely raise rates under the existing structure. The rate raise had to be in conjuncture with a broadening of the base.

First, the 1932 Act not only directly raised rates, but also narrowed the tax brackets.<sup>39</sup> But in addition to these higher rates, and a quicker escalation into the top bracket, the Act broadened the base. It accomplished this second important goal by lowering the lifetime exemption, with the estate tax exemption dropping from \$100,000 to \$50,000 per taxpayer.<sup>40</sup> All of a sudden, a series of taxpayers who had been exempt from taxation were brought into the tax base. And not only were they brought into the

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36. Cooper, *supra* note 24, at 885 (quoting 75 CONG. REC. 5906 (1932) (statement of Rep. Swing)).

37. *Id.*

38. Carolyn C. Jones, *The Moral Hazard of the Estate Tax*, 48 CLEV. ST. L. REV. 729, 745 (2000) (quoting RANDOLPH E. PAUL, *TAXATION IN THE UNITED STATES* 230 (1954)).

39. For example, under the prior Revenue Act, the lowest brackets were \$0–\$50,000 (net estate value) at 1 percent, \$50,000–\$150,000 at 2 percent, and \$150,000–\$250,000 at 3 percent. Revenue Act of 1926, 69 Pub. L. No. 20, sec. 322, § 301(a), 44 Stat. 9, 85–86. However, under the Revenue Act of 1932, the five lowest tax brackets were only at \$10,000 increments. For example, the first bracket of 1 percent was \$0–\$10,000, the next 2 percent bracket was \$10,000–\$20,000, etc., thus moving an estate much more quickly up the marginal rate scale. Revenue Act of 1932 § 401(b).

40. Compare Revenue Act of 1932 § 401(c), with Revenue Act of 1926 § 303(a)(4).

base, but that base also had a quickly escalating rate structure.

The other significant design feature of the estate tax provisions of the 1932 Act was that they contained no expiration date.<sup>41</sup> Unlike the prior ad hoc or short-term uses of the estate tax, this time the tax was here to stay. It is debatable if the permanency was a true design element or instead sleight of hand, but certainly in the same Act Congress enacted many taxes, such as the manufacturers' excise taxes, that would automatically expire.<sup>42</sup> So, the fact that the 1932 Act had no estate tax expiration is significant.

The estate tax increase resulted not only in increased revenue at the top end, but also substantial rate increases at the bottom. The top tax bracket received a tax increase of over 100 percent.<sup>43</sup> Prior to the 1932 Act, a \$10,000,000 estate would owe about \$1,300,000 in federal estate taxes; after the reform, it would owe a little over \$3,000,000.<sup>44</sup> Working down from the top bracket, the rate increase would then increase the tax due by about \$250,000 for every \$1,000,000 in taxable estate value.<sup>45</sup>

The revisions significantly impacted more than just the top brackets. The smaller estate revenue raise in absolute dollars was de minimis compared to the top brackets. However, in relative terms it was actually much higher. A \$150,000 estate would, after the revisions, owe \$5,000, compared to \$500 before the 1932 Act: a 1,000 percent increase.<sup>46</sup>

### 3. 1948–76

Once the permanent estate tax (with a relatively high level of exemption compared to average estate value) was firmly established, it enjoyed a sustained period of stability. During this period, the income tax was being tested by the impact of community property rules. In community property states, income was shared equally. Thus, for “income tax purposes, married couples in community law property states would split the income while married couples in common law property states would be required to allocate income to the earner.”<sup>47</sup>

At the time, rates were steeply progressive, resulting in a large differential. The rates steadily increased until 1941, when the rates went to

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41. Cooper, *supra* note 24, at 894.

42. *Id.*

43. *See id.* at 898 tbl.1.

44. *Id.* at 898 (“An estate valued at \$10,000,000 would have owed \$1,334,500 in federal estate taxes prior to the 1932 Act and \$3,094,500 thereafter—a massive increase of \$1,760,000.”).

45. *Id.*

46. *Id.*

47. Herzig, *Marriage*, *supra* note 29, at 21.

77 percent.<sup>48</sup> At the peak of the marginal rate disparity, a similarly situated married couple in a common law property state would pay about 41 percent more than the community property couple.<sup>49</sup> Thus, in 1948, Congress was forced to address the income tax disparity in the Revenue Act of 1948 (“1948 Act”).

Simultaneously, as a tagalong, and without consideration, Congress entirely revamped the estate and gift tax laws.<sup>50</sup> Contemporary critics called the Act “hastily constructed [with] incompletely analyzed sections that overnight changed their entire operation.”<sup>51</sup> The changes were such a shock to the practicing bar that an unusually high burden was put on taxpayers, because “lawyers [had] not had adequate opportunity to read, understand, and act.”<sup>52</sup> The 1948 Act created the marital deduction, the terminable interest rule, the income tax basis in community property surviving spousal shares, and substantial revisions to the gift tax.<sup>53</sup>

The reasons behind Congress’s changes were the problems that had resulted from attempts to harmonize the various tax effects of community property and common law property rules. Leading up to 1942, a concerted drive sought to end the income tax advantage in community property states.<sup>54</sup> In 1942, a compromise was reached, allowing the income tax advantage in community property states to continue at the sacrifice of the estate and gift tax advantages.<sup>55</sup> At the husband’s death, the entire community property estate (except that directly traceable to the wife) would be included in the husband’s estate.<sup>56</sup> This changed the rule that only half was included. On the other hand, at the wife’s death, one-half of the assets would be included in the estate. The gift tax was similarly revised to reflect a mirror rule.<sup>57</sup> These revisions were met with legal challenges,<sup>58</sup> and well as questions from officials and from the bar regarding practical

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48. Carlyn S. McCaffrey & John C. McCaffrey, *Our Wealth Transfer Tax System—A View from the 100th Year*, 41 ACTEC L.J. 1, 15 (2015).

49. *Id.*

50. Stanley S. Surrey, *Federal Taxation of the Family—The Revenue Act of 1948*, 61 HARV. L. REV. 1097, 1117–1119 (1948).

51. *Id.* at 1117.

52. *Id.*

53. *See id.* at 1117–40.

54. *See id.* at 1118.

55. *See id.*

56. *Id.*

57. *Id.*

58. *See generally* *Fernandez v. Wiener*, 326 U.S. 340 (1945) (challenging, unsuccessfully, the taxing power regarding the entire community property estate, including its constitutionality).

application.<sup>59</sup> The 1948 Act restored the pre-1942 community property rules.<sup>60</sup> Congress, instead of equalizing community property with common law property, then attempted to equalize common law property with community property. This was done in the estate and gift arenas through a parallel analysis of income tax rules. Unfortunately, estate and gift tax rules have very little in common with the income tax.<sup>61</sup>

The main tool used by Congress to equalize the treatment of common and community property within the estate tax was the introduction of the new marital deduction.<sup>62</sup> In general, the marital deduction allowed for a deduction from the gross estate of an amount not to exceed one-half of the estate for assets passing to the surviving spouse.<sup>63</sup> This allowed equalization for common law and community property spouses. Now, in both cases, one-half of the assets would be taxed at death.

However, the marital deduction could not be fully applied to community property. If it applied, the husband would have been taxed on just one-half of the one-half of the estate. To avoid a misapplication of the formula, a further adjustment was needed to the gross estate. The gross estate was thus reduced by the community property included. One would be eligible for the marital deduction if a share of the community property were left to the survivor.<sup>64</sup>

The estate tax now included two new concepts within the idea of an interest “passing” to a “spouse.”<sup>65</sup> In this new version of the tax, one had to determine both the amount passing and who was a spouse. Now, valuation would become a central theme of the estate tax.<sup>66</sup>

Moreover, since the rationale of the new rules to “pass” was tied to an equalization of the common and community law principles, it became necessary to ensure that the interest passing was equivalent. This was a qualitative effort to ensure that the interest was the same. Thus, Congress introduced the terminable interest rule.<sup>67</sup>

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59. See, e.g., *Individual Income Tax Reduction: Hearing Before the S. Comm. on Fin. on H.R. 1*, 80th Cong. 487–90 (1948) (statement of Stanley S. Surrey, Tax Legislative Counsellor, Treasury Department); 94 CONG. REC. 3575 (March 29, 1948); Surrey, *supra* note 50, at 1118–19.

60. Surrey, *supra* note 50, at 1119–20.

61. *Id.* at 1119–21.

62. *Id.* at 1120–21.

63. *Id.* at 1121.

64. *Id.* at 1122–23.

65. *Id.* at 1125.

66. See *id.* at 1127.

67. See *id.*

To qualify, the interest had to have three factors present. First, the interest passing had to terminate or fail by reason of lapse of time or occurrence of an event.<sup>68</sup> Second, the interest had to pass for full and adequate consideration. Third, the interest had to not possess or enjoy any part of the property after the interest terminated.<sup>69</sup> The rule was designed so that only a fee simple interest would qualify.<sup>70</sup> The traditional life estate interest would *not* qualify because it does not resemble the “complete interest of the community property spouse.”<sup>71</sup>

The terminable interest rule had many exceptions. The largest exception to the terminable interest rule, introduced in 1948, was through “power of appointment trusts.”<sup>72</sup> In such trusts, as long as the trust income was payable at least annually to the spouse, and the spouse had the power to appoint the entire corpus, the trust would qualify as terminal interest property.<sup>73</sup> The other two exceptions to the terminable interest rule were more minor and were related to types of property that could be acquired.<sup>74</sup>

Finally, in order to finalize the equalization of community property and common law, the income tax basis of the inherited assets had to be addressed. Under the rules, the income tax basis of the surviving spouse was fixed at the fair market value.<sup>75</sup> In a community property state, only one-half of the property was deemed to have passed from the surviving spouse and thus received the basis step-up. The effort to harmonize the estate tax created a significant income tax discrepancy. According to contemporaneous commenters, a more thoughtful examination could have resulted in alternatives that harmonized the two state property schemes.<sup>76</sup> However, in short time, a remedy was put in place allowing for a double basis step-up in community property states.<sup>77</sup> The result was that in common law states, the basis would remain unchanged; in community

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68. *Id.* at 1128.

69. *Id.*

70. *Id.*

71. *Id.* at 1129. This also means that conditions such as “so long as my wife remains unmarried,” would not qualify, because the interest may terminate.

72. A. James Casner, *Estate Planning Under the Revenue Act of 1948—The Regulations*, 63 HARV. L. REV. 99, 99–100 (1949).

73. *See id.* at 100–06.

74. *Id.*

75. Boris I. Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389, 1457 (1975). *See also* I.R.C. §§ 267(a), 267(c)(4) (2012).

76. *See* Bittker, *supra* note 75, at 1457; Casner, *supra* note 72, at 105; Surrey, *supra* note 50, at 1129.

77. Jeremy T. Ware, *Section 1014(b)(6) and the Boundaries of Community Property*, 5 NEV. L.J. 704, 705 (2005).

property law states, the basis was stepped-up to fair market value.<sup>78</sup>

After 1948, there was a wholly new approach to the estate tax. In that year's effort to remake the tax to equalize the treatment of the various property law regimes, the hastily enacted tax created certain inequities. From 1948 until 1976, the estate tax remained fundamentally unchanged.<sup>79</sup>

## B. MODERN ESTATE TAX

In 1976, Congress revamped the income, estate, and gift taxes. The Tax Reform Act of 1976 ("1976 Act") merged the estate tax exclusion with the lifetime gift tax exclusion to create a single unified estate and gift tax.<sup>80</sup> Prior to 1976, there were lower rates applied to gifts than to estates. Thus, leaving property at death was significantly more costly than passing property during life.

Although change happened in 1976, unlike in 1948, that change was a decade or more in development. The TRA of 1976 was prompted by the need to finally address the failure of Congress to substantially change the estate and gift tax since the introduction of the marital deduction in 1948.<sup>81</sup> Thus, in reviewing the basic scheme, Congress opened up the discussion to not only modification of the rates, but also alternative approaches to taxation.

In 1969, the American Law Institute and the Treasury Department produced studies outlining reforms necessary as a result of the application of the 1948 Act.<sup>82</sup> The goal of the 1976 revision which followed was to improve the structure of the estate and gift tax: "Congress endeavored to

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78. See *Willging v. United States*, 474 F.2d 12, 14 (9th Cir. 1973). *Accord* *Bath v. United States*, 323 F.2d 980, 981 (5th Cir. 1963). See also S. REP. NO. 80-1013, at 29 (1948).

79. Herzig, *supra* note 20, at 1104-05 (citing *Tax Reform Act of 1975: Hearing Before the S. Comm. on Fin. on H.R. 10612*, 94th Cong. 22, 79 (1976) (statement of William E. Simon, Secretary of the Treasury)) ("Moreover, the basic structure of the estate and gift taxes had remained fundamentally unchanged since 1932.").

80. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001, 90 Stat. 1846, 1846-48 (codified as amended at I.R.C. § 2001) (imposition and rate of estate tax); *id.* § 2010 (gift tax rate and credit). See also I.R.C. §§ 2502, 2505 (unified credit against estate tax).

81. H.R. REP. NO. 94-1380, 94th Cong., at 5 (1976); H. COMM. ON WAYS & MEANS, 94TH CONG., ESTATE AND GIFT TAX HEARINGS 9-11 (Comm. Print 1976) [hereinafter 1976 ESTATE AND GIFT TAX HEARINGS] (statement of William E. Simon, Secretary of the Treasury). See also Bridget J. Crawford, *One Flesh, Two Taxpayers: A New Approach to Marriage and Wealth Transfer Taxation*, 6 FLA. TAX REV. 757, 770 (2004).

82. See generally U.S. TREASURY DEP'T, TAX REFORM STUDIES AND PROPOSALS (Comm. Print. 1969) (joint publication of H. Comm. on Ways and Means & S. Fin. Comm.) [hereinafter 1969 Treasury Proposals]; AM. LAW INST., FEDERAL ESTATE AND GIFT TAXATION: RECOMMENDATIONS OF THE AMERICAN LAW INSTITUTE AND REPORTERS' STUDIES (1969). See also Graetz, *Praise*, *supra* note 9, at 259-60.

produce a structurally more coherent tax—to move toward a genuinely progressive estate and gift tax, typically to be imposed once each generation without huge tax disparities due to decedents' patterns of lifetime giving."<sup>83</sup>

At death, heirs historically received a new fair market value basis in the property they inherited.<sup>84</sup> This rule is called the “stepped-up basis” rule.<sup>85</sup> In 1976, there was much debate about the fairness, truly a consumption tax debate, on whether the “stepped-up basis” created two forms of inequity.<sup>86</sup> First, this system favored taxpayers who acquired wealth through unrealized appreciation of the value of their property over those who acquired wealth through previously taxed income (e.g., wages).<sup>87</sup> Second, it allowed families to time when tax on the unrealized appreciation would happen.<sup>88</sup>

To create more vertical and horizontal equity,<sup>89</sup> Congress proposed three alternatives. In 1976, the three main solutions proposed were: (1) to

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83. Graetz, *Praise*, *supra* note 9, at 260.

84. 1976 ESTATE AND GIFT TAX HEARINGS, *supra* note 81, at 11. *See also Estate and Gift Tax Carryover Basis and Generation-Skipping Trust Provisions and Deductibility of Foreign Convention Expenses: Hearing Before the H. Comm. on Ways & Means*, 95th Cong. 266 (1977) [hereinafter *Estate and Gift Tax Carryover Basis*] (written statement of Bernard M. Shapiro) (“Prior to the Tax Reform Act of 1976, the basis of property acquired from, or passing from, the decedent was the fair market value of that property on the date of the decedent’s death . . .”).

85. *See* I.R.C. § 1014(a) (2012).

86. *See* Karen C. Burke & Grayson M.P. McCouch, *Estate Tax Repeal: Through the Looking Glass*, 22 VA. TAX REV. 187, 197 (2002); Calvin H. Johnson, *Elephant in the Parlor: Repeal of Step-up in Basis at Death*, 121 TAX NOTES 1181, 1183 (2008).

87. Johnson, *supra* note 86, at 1183. This is a complicated concept often argued in tax policy discussions. Essentially, assume that you have two taxpayers: A and B. Taxpayer A accumulates wealth through a wage-oriented job. Taxpayer B accumulates wealth through investment in stocks. Taxpayer A is taxed at ordinary income rates each year. Taxpayer B defers taxation on the investment each year. At death, Taxpayer A is taxed on the value of his estate again, while Taxpayer B is taxed for the first time on the value of her estate.

88. *See* Johnson, *supra* note 86, at 1181 (“The exemption for built-in gain at death is unfair because it allows consumption, even sumptuous consumption of investments by heirs, without either the heir or original owner paying tax on the consumption.”); *Estate and Gift Tax Carryover Basis*, *supra* note 84, at 7 (statement of John S. Pennell, Chairman, Section of Taxation, American Bar Association) (“Present [before the 1976 Act] law results in an unwarranted discrimination against those persons who sell their property prior to death as compared with those whose property is not sold until after death.”); *id.* at 7 (statement of John S. Pennell, Chairman, Section of Taxation, American Bar Association) (“The of effect of this ‘lock-in’ effect is often to distort allocation of capital between competing sources.”).

89. Louis M. Castruccio, *Becoming More Inevitable? Death and Taxes . . . and Taxes*, 17 UCLA L. REV. 459, 478, 481 (1970). *See also Estate and Gift Tax Carryover Basis*, *supra* note 84, at 8 (statement of John S. Pennell, Chairman, Section of Taxation, American Bar Association) (“[I]t is essential that in applying the principle of equity (i.e., achieving the same tax treatment for taxpayers of similar economic circumstances) that the full impact of both death taxes and income taxes generated by the sale of assets to pay these taxes be considered.”).

impose a capital gains tax on unrealized appreciation in the estate;<sup>90</sup> (2) to replace the stepped-up basis rules with carryover basis rules applicable in the gift tax arena;<sup>91</sup> and (3) to add an additional estate tax on the amount of unrealized appreciation in the estate.<sup>92</sup> The carryover basis alternative was passed without hearings. During the hearings *after* the passage of the legislation, all three alternatives were discussed in greater detail.<sup>93</sup>

The other significant change was the enactment of the generation-skipping tax.<sup>94</sup> Prior to the enactment of a generation-skipping tax, individuals could leave money in trust for their children's lifetime and, at the death of the child, to the grandchild. The money left to the trust would be taxed in the estate of the decedent and in the estate of the grandchildren. But prior to the generation-skipping tax, it would not be taxed at the intervening death of the children.

Carryover basis was the choice initially accepted by Congress.<sup>95</sup> The problem with this approach is that it was chosen without the testing and investigation that occurs through a normal legislative process: that is, through the House Committee on Ways and Means and in public Senate hearings.<sup>96</sup> "Congress then reversed direction a few years later and moved to emasculate it. In 1980, Congress repealed the carryover-basis rules and returned to the unfair and economically distorting step-up of basis to fair market value at death."<sup>97</sup> This was accomplished because it was said that carryover basis had a number of implementation problems.

First among these were administrative complexities for the taxpayer,

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90. 1976 ESTATE AND GIFT TAX HEARINGS, *supra* note 81, at 5, 12. The failure to tax this appreciation has been referred to the "most serious defect" in our tax system. Kurtz & Surrey, *supra* note 9, at 1381. See also Karen C. Burke & Grayson M.P. McCouch, *Death Without Taxes?*, 20 VA. TAX REV. 499, 510–11 (2001).

91. 1976 ESTATE AND GIFT TAX HEARINGS, *supra* note 81, at 12. See also *Estate and Gift Tax Problems Arising from the Tax Reform Act of 1976: Hearing Before the Subcomm. on Tax'n & Debt Mgmt. Generally of the S. Comm. on Fin.*, 95th Cong. 108 (1977) (statement of Joseph Kartiganer, Partner, White & Case).

92. 1976 ESTATE AND GIFT TAX HEARINGS, *supra* note 81, at 11–12.

93. See *Estate and Gift Tax Carryover Basis*, *supra* note 84, at 99–100 (discussing how the carryover basis alternative should be implemented); *id.* at 36 ("For the longer run, we probably ought to consider whether alternative forms of wealth taxation might not offer a more efficient and more fair manner of taxing the wealthy elite than the estate and gift tax. For example, an annual net worth tax is standard part of European tax structures.").

94. Tax Reform Act of 1976, Pub. L. No. 94-955, § 2006, 90 Stat. 1846, 1879–90 (codified as amended at I.R.C. §§ 2601–03, 2611–14, 2621–22 (1976 & Supp. V 1981)).

95. See *id.* § 2005.

96. Graetz, *Praise*, *supra* note 9, at 261.

97. *Id.* at 262.

the executors, the IRS, and the descendants who receive the property<sup>98</sup>. The focus of the administrative complexity had two components: (1) record-keeping;<sup>99</sup> and (2) orderly administration of an estate.<sup>100</sup> Further, as the hearings proved out, the implementation of the rules was a challenge,<sup>101</sup> and the IRS had little capacity for enforcement.<sup>102</sup> Taxpayers could make reasonable estimates to their basis in assets.<sup>103</sup> This shows the problems with the implementation. All the flaws—the most striking being the lack of commentary before the passage of this law—led Congress to retroactively repeal the carryover basis rules in 1980.<sup>104</sup>

### C. THE 1980 PHILOSOPHICAL SHIFT

Essentially by 1980, a new narrative was entrenched, and in operation, a fundamental ideological shift regarding the estate tax had taken place. Since 1980, all changes made to the estate tax have essentially chipped away at the goal of breaking up wealth concentration and instead focused on creating income tax advantages for the wealthy. In 1976, Congress had

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98. See *Estate and Gift Tax Carryover Basis*, *supra* note 84, at 44 (Statement of John Butala, Jr., Co-Chairman of the Taxation Committee, American Bankers Association) (“In our opinion, the carryover basis law improperly intrudes upon the normal administration of an estate.”); *id.* at 57 (statement of American Bankers Association) (providing examples of actual carryover basis problems for estates in Appendix A).

99. *Id.* at 4–5 (statement of John S. Pennell, Chairman, Section of Taxation, American Bar Association) (testifying that the average farmer with 300 acres of land valued at \$1,500 an acre—who would now be subject to the carryover basis rules—had not kept records.); *id.* at 43–44 (statement of John Butala, Jr.) (discussing the “countless hours in futile attempts to ascertain cost figures”); *id.* at 57 (Statement of American Bankers Association); *id.* at 76, 78–80 (statement of Raymond E. George, Jr., Senior Vice President, Northern Trust Company) (providing actual studies of the extra man hours needed for both large and small estates); 1976 ESTATE AND GIFT TAX HEARINGS, *supra* note 81, at 88 (Statement of Michael J. Graetz, Professor of Law, University of Virginia) (“[C]arryover proposals require not only determination of the basis of transferred assets but also maintenance of records of basis over several generations.”).

100. *Estate and Gift Tax Carryover Basis*, *supra* note 84, at 12 (statement of John S. Pennell) (“All estates, regardless of size, are required to make basis adjustments, file notices, and comply with a myriad of other complex and needless details.”); *Estate and Gift Tax Problems*, *supra* note 91, at 8 (statement of Lewis M. Costello, Esq.) (“Every generation, no matter how badly the records were kept during lifetime, if they paid tax on what they owned at death, could begin over again and all past sins were forgiven.”).

101. Joseph M. Dodge & Jay A. Soled, *Debunking the Basis Myth Under the Income Tax*, 81 IND. L.J. 539, 566 (2006); Zelenak, *supra* note 9, at 371.

102. Dodge & Soled, *supra* note 101, at 541–42.

103. See *Estate and Gift Tax Carryover Basis*, *supra* note 84, at 5 (statement of John S. Pennell) (arguing taxpayers will use the rules of evidence to submit false basis statements and the IRS will not be able to challenge it); *id.* at 71–72 (statement of Arthur S. Hoffman, American Institute of Certified Public Accountants) (“Congress must consider how much complexity can be introduced into the tax law before an individual’s desire to voluntarily comply is quashed.”).

104. See Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 401(a), 94 Stat. 229, 299.

considered all the options available and chose what would be a considered a “well-structured wealth transfer tax system.”<sup>105</sup> By 1980, though, following lobbying and complaints by the top-tier taxpayers, Congress went back to the “unfair and economically distorting step-up of basis to fair market value at death.”<sup>106</sup>

This retroactive repeal of the heart of the 1976 Act was followed up in 1981 with rules further reducing the number of estates subject to tax. Through this, Congress exacerbated the distortion problems by increasing the tax-exempt level to \$275,625 and further phasing out transfer taxes for estates with a net worth of \$600,000 or less.<sup>107</sup> Congress then also expanded the marital deduction by enacting the Qualified Terminable Interest Property (“QTIP”) trust provisions and extending the marital deduction to all estates.<sup>108</sup> The result of the rollback of 1981 was that the tax base shrunk by around 70 percent.<sup>109</sup>

Once the 1981 rollbacks were fully implemented, only 15 percent of the unrealized appreciation of estates was subject to either income or estate taxation.<sup>110</sup> By reducing the impact of the estate tax, hardly any estates paid tax, which then created the dominant narrative of the next thirty years—that the estate tax should be eliminated because of the limited revenue raised from the smaller base.

Almost twenty years after this political reformation of the estate tax was implemented, an additional campaign took place in the late 1990s seeking to repeal the entire estate tax regime.<sup>111</sup> The unified tax regime that arose after 1980-81 now faced a head-on attack as “unfair, counterproductive, and even immoral.”<sup>112</sup>

The Taxpayer Refund and Relief Act of 1999 (“1999 TRRA”) provided for an ultimate repeal over a ten-year period of phased-in reductions in the rate.<sup>113</sup> The ultimate goal of the tax was to provide a

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105. Graetz, *Praise*, *supra* note 9, at 262.

106. *Id.*

107. See Economic Recovery Tax Act of 1981, Pub. L. 97-34, § 401(a)(2)(A), 95 Stat. 172, 299 (codified at I.R.C. § 2010(b) (Supp. V 1981)); Graetz, *Praise*, *supra* note 9, at 262.

108. See Economic Recovery Tax Act of 1981 § 403(a)(1) (codified at I.R.C. § 2056 (1976 & Supp. V 1981)).

109. Graetz, *Praise*, *supra* note 9, at 262 (citing revenue losses projected in H.R. REP. NO. 215, 97th Cong., at 291 (1981)).

110. *Id.* at 263.

111. See Grayson M.P. McCouch, *The Empty Promise of Estate Tax Repeal*, 28 VA. TAX REV. 369, 371 (2008).

112. Burke & McCouch, *supra* note 86, at 188; Herzig, *Marriage*, *supra* note 29, at 324.

113. Taxpayer Refund and Relief Act of 1999, H.R. 2488, 106th Cong. § 601; STAFF OF JOINT

graduated basis step-up for the first fixed amount of assets and then a carryover basis for the remainder.<sup>114</sup> This new position of repeal gained enough momentum that Congress voted to repeal the estate tax, only to be stopped by a presidential veto.<sup>115</sup> The veto was based on the fact that the tax was a reduction for those who needed it the least.<sup>116</sup>

Then again in 2000, Congress passed the Death Tax Elimination Act of 2000 (“2000 DTEA”).<sup>117</sup> The 2000 DTEA, in a similar vein to the 1999 TRRA, phased in the reduction over ten years.<sup>118</sup> Once again, Congress was focused on replacing the stepped-up basis with a carryover basis for property over a certain amount.<sup>119</sup> President Clinton followed up with another veto of the 2000 DTEA. “‘This is a misguided bill that provides a huge tax cut to the most well-off Americans at the expense of working families,’ Mr. Clinton said.”<sup>120</sup>

The veto was almost overturned, falling about sixteen votes short.<sup>121</sup> Republicans declared an eagerness to use this issue in the upcoming campaign. “[T]hey said a repeal would attract support from small-business owners, farmers, entrepreneurs and other voters who object to having part of their wealth taxed when they pass it to their heirs.”<sup>122</sup>

Not surprisingly, during the 2000 election cycle, a major part of George W. Bush’s campaign was cutting and reducing taxes,<sup>123</sup> and part of the new Republican strategy was a rebranding of the estate tax. In a successful political maneuver, opponents of the estate tax changed public opinion, recasting—as the failed bill had done—the estate tax as a “death

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COMM. ON TAXATION, 106TH CONG., SUMMARY OF THE REVENUE PROVISIONS OF THE CONFERENCE AGREEMENT ON H.R. 2488, THE “TAXPAYER REFUND AND RELIEF ACT OF 1999” 10 (Comm. Print 1999) (“Reduction and Repeal of Estate, Gift, and Generation-Skipping Transfer Taxes”); Annick, *supra* note 22, at 98–99.

114. Annick, *supra* note 22, at 99.

115. *Id.* at 98–99. *See also* Death Tax Elimination Act of 2000, H.R. 8, 106th Cong. § 101; Taxpayer Refund and Relief Act of 1999 § 601.

116. 145 CONG. REC. H8613 (1999) (recording President Clinton’s veto message).

117. *See* 146 CONG. REC. D746 (2000).

118. *See* Death Tax Elimination Act of 2000 §§ 101–03, 201.

119. Annick, *supra* note 22, at 100 (“The Act provided that the first \$1.3 million worth of asset transfers, and the first \$3 million of transfers to a surviving spouse, would receive stepped-up basis.”).

120. Richard W. Stevenson, *Veto of Estate-Tax Repeal Survives Vote in the House*, N.Y. TIMES (Sept. 8, 2000), <http://www.nytimes.com/2000/09/08/us/veto-of-estate-tax-repeal-survives-vote-in-the-house.html>.

121. The actual vote was 274 to 157. If the entire House had voted, then 290 votes would have been needed. If we look to just the number of votes cast, only 288 were needed. *See id.*

122. *Id.*

123. Burke & McCouch, *supra* note 86, at 188.

tax.”<sup>124</sup> Then, picking up on the successful strategy of 1980, the reformers focused on the tax’s theoretically problematic application to farmers and small business owners, instead of on the progressive nature of the tax.<sup>125</sup> Upon winning the election, President Bush proposed a budget with massive tax cuts, which included the repeal of the estate tax as a key component.<sup>126</sup> Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) four months after Bush’s inauguration.<sup>127</sup>

Matching the two vetoed bills from 1999 and 2000, the EGTRRA essentially was estate tax elimination over a phased-in time frame.<sup>128</sup> Total elimination of the estate tax would not comply with the Byrd rule for a balanced budget, so the reduction was accomplished through a continuous raise in the exemption amount.<sup>129</sup> The concession to the Byrd rule was that if Congress did nothing in 2010 to continue the elimination, EGTRRA would sunset.<sup>130</sup> During the 2010 elimination year, EGTRRA provided a carryover basis regime for decedents.<sup>131</sup> At the end of 2010, prior law would be reinstated.

The compromise was an exchange of the gift tax for a greater step-up in basis. The EGTRRA retained the gift tax.<sup>132</sup> With the keeping of the gift tax, Congress could slate a greater basis step-up and still meet the Byrd rule. Under the EGTRRA, a basis increase of \$1.3 million per decedent, plus an additional \$3 million for qualified marital transfers, was granted.<sup>133</sup>

124. Annick, *supra* note 22, at 98–99. *See also* Burke & McCouch, *supra* note 90, at 513.

125. Annick, *supra* note 22, at 98; Dennis J. Ventry Jr., *Straight Talk About the ‘Death’ Tax: Politics, Economics, and Morality*, 89 TAX NOTES 1159, 1162 (2000).

126. *See* Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16 tit. V, 115 Stat. 38, 62 (codified as amended at scattered sections of I.R.C.).

127. *See* 147 CONG. REC. D499 (2001).

128. *See* I.R.C. § 2001(c)(2) (2002). *See also* Jonathan G. Blattmachr et al., *The Impossible Has Happened: No Federal Estate Tax, No GST Tax, and Carryover Basis for 2010*, 112 J. TAX’N 68, 68–69 (2010); Burke & McCouch, *supra* note 86, at 188.

129. Blattmachr et al., *supra* note 128, at 69 (explaining the Byrd rule’s prohibition on using reconciliation to pass revenue reduction measures which would extend beyond the reconciliation period).

130. Economic Growth and Tax Relief Reconciliation Act of 2001 § 901(a).

131. *See id.* § 1022.

132. *See* 147 CONG. REC. H2726, H2771 (2001). The decision to keep the gift tax was the consequence of a memo from the Joint Committee on Taxation, which estimated large revenue losses as a result of tax avoidance schemes. *See* McCouch, *supra* note 111, at 375 n.19. *But see* Burke & McCouch, *supra* note 86, at 223–28 (positing that the retained gift tax was an ineffective method of mitigating revenue loss and deterring income shifting, and was merely a political gesture to disguise the impact of the new regime).

133. *See* I.R.C. § 1022(b) (2006) (repealed 2010). The basis of any property could not be increased above its fair market value on the date of the decedent’s death. *Id.* § 1022(d)(2). *See also* Dodge & Soled, *supra* note 101, at 591–92.

The result of the EGTRRA was that “a married couple could add up to \$5.6 million of basis to their historical basis.”<sup>134</sup>

Despite the battle seemingly having been won, at the time the EGTRRA was passed virtually no one believed that Congress would fail to act before 2010 and allow permanent carry-over basis.<sup>135</sup> After all, the sunset provision cascading into carryover basis was a compliance provision solely for the Byrd rule, rather than a desired feature of the Act.<sup>136</sup>

The primary problem with the EGTRRA was that it allowed the tax base to continue to shrink. The shrinking of the base allowed the conflated narrative of limited application to become further entrenched in the estate tax story. No longer were the original progressive ideals which had dominated the first sixty years of the tax’s history, the primary focus. Those important criteria were now replaced with calls for repeal of a broken tax which hardly raised any revenue.

To further this narrative in support of total repeal, it is difficult to estimate the effects of estate tax elimination with carryover basis. The main problem in calculating the impact is the lack of a specific date of a sale. Without estate tax due, beneficiaries could retain the inherited property theoretically forever. This indefinite period (*t*) makes a forecast impact number of either zero—that is, no sale assumption ever; or all—that is, assuming sale immediately.<sup>137</sup> But there were models that estimated the effects of repeal of estate tax combined with a limited step-up.<sup>138</sup>

The important take away from these studies was a highlighting of the asset composition. Large estates had, on average, 70 percent of their total assets consisting of unrealized capital gains.<sup>139</sup> Thus, under these models, a repeal with modified carryover basis would result in net revenue of

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134. Annick, *supra* note 22, at 101.

135. Blattmachr et al., *supra* note 128, at 68 (“Although the Code has provided that there would be no estate or GST tax for 2010 since the passage of EGTRRA, few thought it could happen.”); Burke & McCouch, *supra* note 86, at 201; William G. Gale & Samara R. Potter, *An Economic Evaluation of the Economic Growth and Tax Relief Reconciliation Act of 2001*, 55 NAT’L TAX J. 133, 138 (2002) (“Virtually no one believes the bill will sunset as written.”).

136. Burke & McCouch, *supra* note 86, at 188 n.4, 201.

137. Burke & McCouch, *supra* note 90, at 517.

138. See James M. Poterba & Scott Weisbenner, *The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death*, in RETHINKING ESTATE AND GIFT TAXATION 422, 422 (William G. Gale et al. eds., 2001).

139. Annick, *supra* note 22, at 106 n.255 (“Professors Steger and Rueter arrived at this number, which they acknowledge is higher than the 56% reported in the study done in 2000 by Poterba and Weisbenner (when looking at estates greater than \$10 million), by interviewing estate planning practitioners. The interviewees indicated that often 90% or more of the total value of estate assets is accrued, unrealized capital gains, and the authors then picked an intermediate value.”).

between \$1.1 and \$1.7 billion.<sup>140</sup> If asset composition is critical, then the results should not be a one-dimensional attack of estate tax revenue but an income tax effect also. Those studies were not done.

But there is evidence of the income tax effect. There are common problems of lack of motivation to sell assets. With margin loans and other alternative lending arrangements, taxpayers have almost unlimited access to wealth without actual realization.<sup>141</sup> Further, there is a lot of evidence of a locked-in effect caused by the inheritance of property with attendant tax liabilities.

The procedural aspects of the EGTRRA best demonstrate the manner in which the revenue impacts are hidden. The main difference between the EGTRRA and the 1976 Act was that the EGTRRA included a specific general exemption of \$1,300,000<sup>142</sup> and a \$3,000,000 spousal exemption<sup>143</sup> to be applied to the decedent's assets.<sup>144</sup> Most decedents do not have \$4,300,000 of unrealized appreciation.<sup>145</sup> Because this allocation is not tied to a *total* of \$4,300,000, a large estate may end up with full date-of-death value basis if there was no significant appreciation before death.<sup>146</sup>

Nonetheless, it was thought at the time of enactment that the same implementation problems would exist.<sup>147</sup> Some of the problems were avoided because the EGTRRA repealed the estate tax, versus the continuance of the estate tax in 1976. Further, the EGTRRA avoided the mandatory allocation formulas of 1976.<sup>148</sup>

The main problem ultimately facing the EGTRRA was that the carryover basis conclusion created the same problems that caused the repeal of the 1976 Act. In the 1976 hearings, the majority of testimony involved how to administer estates in a carryover basis regime.<sup>149</sup> Further, the same reporting problems continued to exist.<sup>150</sup> We will thus continue to

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140. Steger & Rueter, *supra* note 22, at 1315–16.

141. See, e.g., Anya Martin, *Using a Margin Loan to Buy a House*, MARKETWATCH (July 25, 2013, 7:30 AM), <http://www.marketwatch.com/story/using-a-margin-loan-to-buy-a-house-2013-07-25>.

142. See I.R.C. § 1022(b) (2006) (repealed 2010).

143. See *id.* § 1022(c).

144. See Burke & McCouch, *supra* note 86, at 202.

145. *Id.* at 205.

146. For example, if a legatee inherits a Picasso worth \$10,000,000, in which the decedent had a basis of \$1,000,000, the executor could increase the basis to \$2,300,000. If instead the painting had a basis of \$9,500,000, the executor could increase the basis to \$10,000,000 and then use the remaining \$700,000 for other assets.

147. See generally Burke & McCouch, *supra* note 86, at 202.

148. *Id.* at 212.

149. See *supra* notes 99–100.

150. Dodge & Soled, *supra* note 101, at 543–45.

have the same long record-keeping duties that Erwin Griswold advocated against.<sup>151</sup>

To attempt to answer the questions raised in 1976 and by dissidents, the EGTRRA imposed a new information-reporting requirement for estate tax returns, with the report due soon after the estate tax return.<sup>152</sup> The EGTRRA required the executor to report the fair market value of the property at death, the decedent's adjusted basis and holding period, and the amount of any basis increase allocated to the property.<sup>153</sup> Unlike with gifts, the recipient of the property was also entitled to receive this information.<sup>154</sup>

#### D. POST-MODERN ESTATE TAX

In 2012, the Bush-era tax cuts were due to expire, creating a so-called fiscal cliff.<sup>155</sup> In response to the expiration of the EGTRRA, Congress passed the American Taxpayer Relief Act ("ATRA").<sup>156</sup> Since 1976, changes to the estate tax—in order to comply with the Byrd rule—had incorporated sunset provisions. The ATRA continued to implement the changes started in 1980. But instead of semi-permanent implementation, the ATRA does not sunset. Most applauded the stability that the new Act brought to the fields of estate, gift, and goods and services tax.<sup>157</sup>

The ATRA permanently extended and modified the estate tax provisions in the EGTRRA, which had sunset in 2010.<sup>158</sup> Instead of

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151. See Herzig, *supra* note 20, at 1059, 1108–09. See also *Estate and Gift Tax Problems*, *supra* note 91, at 147–49 (statement of Erwin N. Griswold, Solicitor Gen. (retired)).

152. See I.R.C. § 6018(c) (2006) (repealed 2010); Blattmachr et al., *supra* note 128, at 85; Burke & McCouch, *supra* note 86, at 216–20. The requirement was partially restored in 2015. See I.R.C. § 6035 (2016).

153. I.R.C. § 6018(c) (2006) (repealed 2010). The law required reporting of: (1) the name and TIN of the recipient of the property; (2) an accurate description of the property; (3) the adjusted basis of such property of the decedent and the fair market value of the property at the time of death; (4) the decedent's holding period of the property; (5) enough information so that the recipient of the property will be able to determine the character of gain on the property upon disposition; (6) the amount of spousal basis increase, if any, allocated to the property; and (7) any information the subsequent regulations require. *Id.*

154. I.R.C. § 6018(e) (2006) (repealed 2010). See also Dodge & Soled, *supra* note 101, at 549–50. Current law again requires information to be provided to the recipient of the property. See I.R.C. § 6035(a)(1) (2016).

155. The fiscal cliff refers to a budget crisis that was expected to occur in January 2013, as a result of laws that were going to expire (including the Bush-era tax cuts), laws that were to go into effect, and the automatic spending cuts mandated by the Budget Control Act of 2011. See generally Budget Control Act of 2011, Pub. L. No. 112-25, 125 Stat. 240.

156. American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313 (2013).

157. See generally Jonathan G. Blattmachr et al., *Congress Finally Gives Us a Permanent Estate Tax Law*, 118 J. TAX'N 75 (2013).

158. See American Taxpayer Relief Act of 2012; Blattmachr et al., *supra* note 157, at 75–76.

retaining or limiting the post-modern estate tax, the ATRA actually upped the ante by introducing portability and raising the step-up basis opportunities to \$10,000,000.<sup>159</sup>

Without the passage of the ATRA, the estate tax would have reverted in 2013 back to the earlier \$1,000,000 per person exemption, with a 55 percent top statutory rate.<sup>160</sup> Further, the state-level wealth transfer tax credit would have been restored.<sup>161</sup> The compromise necessary for the permanence of the bill, to ensure that the bill met the Byrd rule, was a raising of the top rate from 35 percent to 40 percent.<sup>162</sup>

The most important portion of the ATRA from an estate and gift tax perspective was the shift from an estate tax exemption structure to an exemption amount that was portable from spouse to spouse. One of the main complaints and causes of many estate-planning gyrations was the old estate tax exemption.<sup>163</sup> For example, assume that both spouses, as a family, had \$7,000,000, but title to the assets was in the one spouse's name only. In a common law jurisdiction, if the non-monied spouse died first, then that spouse's estate tax exemption would be lost because there would be no assets to fund a trust designed to avoid taxation at both deaths. To avoid this foreseeable problem and minimize taxation, redistribution of assets among the spouses as well as estate planning was required.

In the ATRA, the aforementioned problem no longer exists. Widows and widowers now can add any unused exclusion of the spouse who died most recently to their own exclusion amount with so-called portability.<sup>164</sup> The basic applicable exclusion amount<sup>165</sup> for each individual is \$5 million,<sup>166</sup> indexed for inflation after 2011.<sup>167</sup> The amount is slated to be \$5.43 million for 2015 and may go over \$8 million by 2024, depending on

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159. See American Taxpayer Relief Act of 2012; Lewis Saret, *ATRA: An Unexpected Plus to Your Estate Planning—Part I*, FORBES (Jun. 13, 2013, 10:26 AM), <https://www.forbes.com/sites/lewissaret/2013/06/13/atra-an-unexpected-plus-to-your-estate-planning-part-i>.

160. See Rob Clarfeld, *5 Reasons Why ATRA Is a Great Outcome for Estates*, FORBES (Jan. 8, 2013, 6:18 PM), <https://www.forbes.com/sites/robclarfeld/2013/01/08/5-reasons-why-atra-is-a-great-outcome-for-estates>.

161. *Id.*

162. See I.R.C. § 2001(c) (2012) (for transfers above \$1 million); *id.* § 2641(a)(1).

163. Cf. Blattmachr et al., *supra* note 157, at 76.

164. Miller & Maine, *supra* note 15, at 912–13.

165. I.R.C. § 2010(c)(2); Temp. Treas. Reg. § 20.2010-1T(d)(2) (2012). (This amount is sometimes referred to as the “Portable Amount,” the “Applicable Exclusion Amount,” or the “Applicable Exclusion”).

166. I.R.C. § 2010(c)(3)(A); Temp. Treas. Reg. § 20.2010-1T(d)(3)(i).

167. I.R.C. § 2010(c)(3)(B); Temp. Treas. Reg. § 20.2010-1T(d)(3)(ii).

inflation.<sup>168</sup> Now estate planning is not needed to elect into the most beneficial estate tax treatment of the decedent. Obviously, traditional reasons for estate planning continue to exist, but taxes are no longer the primary driver.

The result of the increase of the exemption amount is a reduction of the number of taxable estates to only about one out of 700 estates owing any estate tax in 2013.<sup>169</sup> This means that 99.9% of estates do not owe any estate tax. Under ATRA, some 2,700 deaths raised about \$14 billion in estate taxes.<sup>170</sup>

A meaningful comparison to the impact in 1975 and 1980 is useful in visualizing the impact of the past revisions. Assume that the 1976 revision did not occur. If so, then in 1975 the estate tax exemption would mean only the wealthiest 6.5 percent of decedents paid estate tax.<sup>171</sup> If the estate tax exemption had remained unchanged in 1980, the wealthiest 10 percent of decedents in 1982 would owe tax.<sup>172</sup> But after the more recent revisions, in relative numbers, a mere fraction of a percent owe estate tax now.<sup>173</sup>

The impact of the graduated erosion of the base since 1976 is dramatic. The 1976 Act's increased exemption level meant an erosion of the tax base by 1981 from 10 percent to 3 percent.<sup>174</sup> The additional 1981 increase resulted in further erosion from 3 percent to less than 1 percent.<sup>175</sup> By the final tinkering in 2012, the base has been eroded to less than 0.1 percent.

Moreover, the targeted beneficiary group of small businesses and family farms do not gain a significant benefit from the tax reduction. According to the Congressional Research Service, only approximately 0.2% of estates that have more than half their value in business assets, will be subject to the ATRA.<sup>176</sup> Of those estates, approximately ninety-four

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168. Rev. Proc. 2014-61, 2014-47 I.R.B. 393 § 3.33; Paul S. Lee, Nat'l Managing Dir., Bernstein Glob. Wealth Mgmt., Venn Diagrams: Meet Me at the Intersection of Estate & Income Tax, Outline of Presentation Before the Estate Planning Council of Northern Nev. (Mar. 11, 2014), at 4, <http://www.epcnevada.org/assets/Councils/NorthernNevada-NV/library/Lee%20Venn%20Diagrams%20Outline%202-18-14.pdf>.

169. HUANG & FRENTZ, *supra* note 16, at 1; *Table T13-0019*, *supra* note 16.

170. *Table T13-0019*, *supra* note 16.

171. Graetz, *Praise*, *supra* note 9, at 263 & n.32 (finding the wealthiest 121,000 decedents filed returns in 1972).

172. *Id.*

173. See HUANG & FRENTZ, *supra* note 16, at 2; Huang & Cho, *supra* note 7.

174. Graetz, *Praise*, *supra* note 9, at 263.

175. *Id.*; Harry L. Gutman, *Federal Wealth Transfer Taxes After the Economic Recovery Tax Act of 1981*, 35 NAT'L TAX J. 253, 253 (1982).

176. JANE G. GRAVELLE, CONG. RESEARCH SERV., R42959, RECENT CHANGES IN THE ESTATE

estates with “half their assets in small business and who expect their heirs to continue in the business are projected to be subject to the estate tax; they constitute 2.5% of total [taxable] estates.”<sup>177</sup> Moreover, less than half of the 2.5% will have liquidity issues related to their payment of the associated estate tax.<sup>178</sup>

As far as family farms, only approximately sixty-five farm estates are projected to be subject to the ATRA.<sup>179</sup> This represents just 1.8% of all taxable estates.<sup>180</sup> Worse yet for the prevailing narrative is less than “1% (0.8%) of farm operator estates [are] projected to pay the tax.”<sup>181</sup> Not only are few family farms even subject to the estate tax—similar to the small businesses projections—but less than one-fourth will have illiquidity as a result of the tax.

The modification of the estate tax beginning in 1976 was wrapped in a narrative surrounding reduction to save the family farm and small businesses.<sup>182</sup> As the exclusion amount increased, the narrative added the lack of revenue raising as an additional rationale for the elimination of the tax.<sup>183</sup> The truth is much further from the narrative. The raising of the exemption amount has only limited the application of the estate tax to the top portion of the top 1 percent. Small businesses and family farms are only in the rarest cases subject to the tax and, to the extent that they are, they do not have liquidity problems as a result of the application of the tax.

Unfortunately, the substantial increase in the exemption amount is just the first part of the equation. Once the estate tax is eliminated or substantially limited through the exemption, the next step is to address basis adjustments. These basis adjustments are dependent on the state property laws in place for the decedent.

For the most part, under I.R.C. § 1014(a), property passing from a decedent takes the “fair market value of the property at the date of the

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AND GIFT TAX PROVISIONS 5 (2015).

177. *Id.*

178. *Id.*

179. *Id.*

180. *Id.*

181. *Id.*

182. See, e.g., H.R. REP. NO. 94-1380, 94th Cong., at 21–22 (1976); Bridget J. Crawford, *The Profits and Penalties of Kinship: Conflicting Meanings of Family in Estate Tax Law*, 3 PITT. TAX REV. 1, 32 (2005); Ryan D. Downs, *A Proposal to Amend Section 2032A to Reduce Restrictions on Cash Leasing of Farm Property*, 73 NEB. L. REV. 342, 344–45 (1994).

183. See PUB. CITIZEN & UNITED FOR A FAIR ECON., SPENDING MILLIONS TO SAVE BILLIONS: THE CAMPAIGN OF THE SUPER WEALTHY TO KILL THE ESTATE TAX 41 (2006), <https://www.citizen.org/sites/default/files/estatetaxfinal.pdf>.

decedent's death."<sup>184</sup> This is generally referred to as the basis step-up, since the vast majority of assets will take an increased basis.<sup>185</sup> The idea behind § 1014 is that the assets were subject to an estate tax at death; thus, like any other sale or exchange, the same income tax rule should result in a "purchase" type basis.<sup>186</sup> This is in sharp contrast to the § 1015 transfer basis that occurs during a gift transfer.<sup>187</sup>

## II. RESPONSIVENESS TO ANOMALIES

I make the argument that under the ATRA, not only has the base decreased, but the income tax effect of basis step-up also makes the lack of taxation more troublesome. The conventional counter to my argument is that the income tax effect cannot be measured, and this premise exaggerates the effect of the basis step-up relative to the estate tax. In this section I will address these concerns in two ways: First, I will discuss historical taxpayer behavior in a similar environment leading up to the 1940 equalization acts. Second, I will discuss the actual current behavior of taxpayers, mirroring the prior patterns, to show the responsiveness of the income tax benefits in a community property system. Taxpayers exhibit mobility in response to taxation, especially at higher income levels. After all, there are significant reasons other than the weather that Florida has a larger population than New York.

### A. DOUBLE BASIS

In 1913, when the modern income tax was introduced, there was little to no consideration of whether the appropriate tax units should be isolated individuals or social groups with family ties.<sup>188</sup> The Treasury Department was faced with a myriad of issues of how to interpret and implement the rule that it should tax the "net income of every individual."<sup>189</sup> Initially, the Treasury Department interpreted the term "individual" as the family unit, i.e., the husband and the wife. This seemingly practical decision ran up against the harsh reality of some states' treatment of marriage. Through the

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184. I.R.C. § 1014(a)(1) (2012).

185. It should be noted that assets may actually step-down in basis, though this is not a frequent occurrence.

186. Cf. I.R.C. § 1014(e) (providing that if appreciated property is acquired by the decedent within one year prior to death and the property passes back to the donor or spouse of the donor, there will be no step-up in basis).

187. See I.R.C. § 1015(d).

188. Bittker, *supra* note 75, at 1391. See also McMahon, *supra* note 29, at 34–35 (noting the cursory nature of the implementation).

189. Stephanie Hunter McMahon, *Political Hot Potato: How Closing Loopholes Can Get Policymakers Cooked*, 37 J. LEGIS. 142, 150 (2012). See also 1913 SEC'Y TREASURY ANN. REP. 5–6.

application of community property principles, families were required to split income.<sup>190</sup> The fundamental concept of community property is that all property acquired during the marriage is owned equally by each spouse. Thus, the income tax consequences of community property law are that each spouse has the right to half the income, regardless of the spouse that earns the money.

As rates continued to skyrocket during World War I, the incentive to shift income became more and more important.<sup>191</sup> The courts agreed with the Treasury Department that taxpayers could be prevented from assigning their income, even if the transfer was effective under state law.<sup>192</sup> The ability of the Treasury Department to hold the line was tested with two Supreme Court decisions: *Poe v. Seaborn*<sup>193</sup> and *Lucas v. Earl*.<sup>194</sup> In those cases, the Court had to examine whether state community property laws would trump the prohibition against income-shifting.<sup>195</sup> The Court concluded that the income vested in the marital unit, not the individual, and therefore half belonged to each spouse.<sup>196</sup>

This income splitting created a distortion among community property states and common law states. As more and more states moved to take advantage of how the community property regime interacted with the federal tax law, Congress responded by attempting to smooth the treatment of the states through a revision in 1948, creating the current joint return requirements.<sup>197</sup> In doing so, Congress essentially imposed the same income tax liability regardless of the manner in which income was generated.<sup>198</sup>

The lesson from the pre-income equalization acts was that not only are taxpayers responsive to rate differences, but states are also. The final push behind the enactment of the joint filing requirements was the substantial number of states moving to community property regimes, in a race to the bottom of the late 1940s. Originally, the disparity had been limited to eight

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190. See Dennis J. Ventry, Jr., *Saving Seaborn: Ownership Not Marriage as the Basis of Family Taxation*, 86 IND. L.J. 1459, 1468–69 & n.42 (2011).

191. *Id.*

192. See Bittker, *supra* note 75, at 1401–02.

193. See generally *Poe v. Seaborn*, 282 U.S. 101 (1930). See also Ventry, *supra* note 190, at 1502–05.

194. See generally *Lucas v. Earl*, 281 U.S. 111 (1930). See also Ventry, *supra* note 190, at 1505–06.

195. See Samuel D. Brunson, *Taxing Polygamy*, 91 WASH. U. L. REV. 113, 120–21 (2013).

196. *Id.* at 120. See also Lily Kahng, *The Not-So-Merry Wives of Windsor: The Taxation of Women in Same-Sex Marriages*, 101 CORNELL L. REV. 325, 361–62 (2016).

197. See *supra* Part I.A.3.

198. Bittker, *supra* note 75, at 1395.

states.<sup>199</sup> In each of these states, the community property rules originated from their Spanish or French antecedents and existed prior to the enactment of the modern income tax.<sup>200</sup> But after the 1942 compromise, states engaged in a vicious competition to draw taxpayers.

A number of states, including Oklahoma, Oregon, Michigan, Nebraska, and Pennsylvania, shifted from common law to community property law systems.<sup>201</sup> Despite the extra work necessary for a state to modify the property law regime across the board, state officials could see the benefit: “the differences between the impact of the Federal income tax as it applies in community property and common law jurisdictions is so great that the use of community property cannot be avoided.”<sup>202</sup> It would be foolhardy to think that as taxpayers show responsiveness to community property rules again, that states would not consider the same rule change.

Why would states move to a community property regime today? States like California and Texas are being discussed in planning seminars as choice-of-law states for community property. How could California, with the highest marginal income tax rate, be a tax destination? This is because it, like Texas, offers community property.

Simply put, if an individual inherits a house from their father who passed away this year, they take the fair market value of the house as their transferred basis. Assume the individual’s father bought the house for \$150,000 in cash, and when he died the house was worth \$2,500,000. The individual inherits the house and takes a § 1014 basis in it of \$2,500,000. The built-in gain disappears because, in theory, it was taken into account in the estate tax burden that initiated the transfer. Conversely, if the individual received the house via gift from their father, assuming the same facts, then they take a transferred basis of \$150,000. The rationale under the gift analysis focuses on the lack of a tax. The gift tax, unlike the estate tax, does not generate a basis step-up.

In community property states,<sup>203</sup> there is an added wrinkle. In a

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199. The original states were Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington. See ALGER B. CHAPMAN, A REPORT ON THE ADVISABILITY OF ADOPTING A COMMUNITY PROPERTY LAW IN NEW YORK STATE 7 (1947).

200. *Id.* at 6–7.

201. Surrey, *supra* note 50, at 1104.

202. Douglas A. Kahn, *The Federal Estate Tax Burden Borne by a Dissenting Widow*, 64 MICH. L. REV. 1499, 1518 n.82 (1966). See also H.R. REP. NO. 1274, 80th Cong., at 23–25 (1948).

203. Currently, for tax purposes, the community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. See I.R.S. PUBLICATION 555 2 (2016). There are two states, Alaska and Tennessee, that are separate property states but allow couples to convert or elect to treat their property as community property. However, it is unclear if I.R.C.

common law state, when one spouse dies with jointly held property, generally only the decedent's half interest receives the basis step-up.<sup>204</sup> But in community property states, I.R.C. § 1014(b)(6) states that property "acquired from or . . . passed from the decedent" includes the whole property, not just half.<sup>205</sup> Moreover, the unlimited marital deduction under I.R.C. § 2056 essentially results in no transfer taxes on the first spouse's death; this basis step-up provides an immediate income tax savings for the benefit of the surviving spouse (rather than the subsequent beneficiaries).

Assume now that a husband and wife had bought a house in San Francisco in 1989 for \$350,000. When the husband died in 2013, the house passed to the wife, who received the full stepped-up basis based on the market value of \$3,500,000 at the husband's death. This is much different than in a common law property state, where the survivor would take the house with their original cost basis of \$175,000 (one-half of \$350,000), plus a § 1014(a) basis of \$1,750,000, for a total basis of \$1,925,000. At current capital gains rates, if the house were sold for \$4,000,000, in a community property state there would be an income tax savings of \$315,000 if the community property basis rules applied.<sup>206</sup>

The foundation for the application of § 1014(b)(6) is rooted in the early disparate tax treatment that favored common law couples.<sup>207</sup> The pertinent time frame for our discussion here is the 1940s. Leading up to the Equalization Act of 1946, the issues of both the benefits and detriments of community property were discussed at length.

Ironically, the passing of § 1014(b)(6) was designed to even the playing field for community property states.<sup>208</sup> However, since the property is not necessarily concentrated in the hands of the husband today, the section actually acts as a tax advantage in community property states. Many of the rules that were amended in the 1940s to equalize community property with common law have now resulted in a benefit to community

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§ 1014(b)(6) would apply. J. Paul Singleton, *Yes, Virginia, Tax Loopholes Still Exist: An Examination of the Tennessee Community Property Trust Act of 2010*, 42 U. MEM. L. REV. 369, 381 (2011).

204. See I.R.C. § 1014(a)(1) (2012); Ware, *supra* note 77, at 704–05.

205. I.R.C. § 1014(b)(6) ("In the case of decedents dying after December 31, 1947, property which represents the *surviving* spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax) or section 811 of the Internal Revenue Code of 1939.") (emphasis added). See Ware, *supra* note 77, at 705.

206.  $(\$415,000 [(\$4,000,000 - \$1,925,000) \times .20] - \$100,000 [(\$4,000,000 - \$3,500,000) \times .20])$ .

207. Herzig, *Marriage*, *supra* note 29, at 20–21.

208. Ware, *supra* note 77, at 705–06.

property states.

### B. JEST TRUST

There is modern evidence of taxpayer responsiveness to the double basis step-up. For example, the planning technique referred to as the “Joint Exempt Step-Up Trust” (“JEST”) was designed to replicate the same double basis step-up enjoyed by community property married couples in a common law state. Through requests of revenue rulings, the designers of the technique believe that they cannot only duplicate the effects of I.R.C. § 1014(b)(6), but also achieve even better outcomes. They further believe that the technique provides other tax and creditor protections.<sup>209</sup>

The JEST trust is merely a funded, jointly established, revocable trust.<sup>210</sup> The key to the technique working is that each spouse owns a separate, equal share in the trust. In order to replicate the community property feature, if the trust is terminated during the life of either spouse, the trust distributes its assets back to each spouse (evenly, unless otherwise agreed).<sup>211</sup> At the death of the first spouse, the trust becomes irrevocable with a general power of appointment by the dying spouse.<sup>212</sup>

This general power of appointment creates full estate tax includability in the first spouse’s estate. To get the step-up in basis, the assets will first be used to fund a bypass trust using the unused exemption amount.<sup>213</sup> The excess assets, if any, will go into an electing QTIP trust under I.R.C. § 2056(b)(7). Under the terms of the QTIP, the assets in the QTIP Trust receive a step-up in basis upon the first spouse’s death and on the surviving spouse’s death.<sup>214</sup>

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209. See I.R.S. Priv. Ltr. Rul. 200604028 (Jan. 27, 2006); I.R.S. Priv. Ltr. Rul. 200413011 (Mar. 6, 2004); I.R.S. Priv. Ltr. Rul. 200403094 (Jan. 16, 2004); I.R.S. Priv. Ltr. Rul. 200210051 (Mar. 8, 2002); I.R.S. Tech. Adv. Mem. 9308002 (Feb. 26, 1993). See also Alan S. Gassman, Christopher J. Denicolo & Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses—Part 1*, EST. PLAN., Oct. 2013 [hereinafter Gassman et al., *JEST 1*], at 3, 3; Alan S. Gassman, Christopher J. Denicolo & Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses—Part 2*, EST. PLAN., Nov. 2013, at 1, 1.

210. See Gassman et al., *JEST 1*, *supra* note 209, at 3.

211. *Id.*

212. *Id.*

213. *Id.* at 21.

214. This technique has been simplified to address the similarity of the community property and common law basis step-up technique. There are some less than clear results of the technique: using the dying spouse’s share when it is less than the exemption amount, funding another bypass trust. According to the promoters, this trust avoids estate taxation at the surviving spouse’s death, notwithstanding that the surviving spouse originally contributed the assets to the JEST.

## C. SECTION 2038 TRUST

The other main technique used by the practicing bar to duplicate the double basis step-up is the “Section 2038 Estate Marital Trust.”<sup>215</sup> In this technique, the settlor creates a trust by contributing assets to a trust for their spouse. On the spouse’s death, the trust assets pass to the spouse’s estate. The key to the technique is that the surviving spouse retains a right to terminate the trust prior to the deceased spouse’s death. If this happens, then the assets must be distributed outright to the surviving spouse. In order to have trust inclusion, the surviving spouse retains the power, in a non-fiduciary capacity, to reacquire or “swap” the trust corpus by substituting other property of an equivalent value.

The trust will not qualify for marital trust or QTIP treatment because there is no requirement to distribute all income annually or for unproductive property to be converted. Nonetheless, the trust likely qualifies for the gift tax marital deduction because the trust pays solely to the spouse’s estate, and thus interest is not a nondeductible terminable interest under I.R.C. § 2523(b).<sup>216</sup>

If the spouse dies first, under § 2031, the trust assets will be includible in the gross estate and thus receive a basis step-up. If the settlor dies first, the trust assets will be includible in the gross estate under § 2038. This is because the gross estate will include the value of all property:

[t]o the extent of any interest therein of which the decedent has at any time made a transfer . . . by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable), either by the decedent alone or by the decedent in conjunction with any person (without regard to when or from what source the decedent acquired such power), to alter, amend, or revoke, or where the decedent relinquished any such power during the 3 year period ending on the date of the decedent’s death.<sup>217</sup>

Either way, this approach subjects the trust to the estate tax for which the exemption will apply and obtains the more important income tax double basis step-up.

Both these techniques show that taxpayers, or at least planners, are currently responsive to the community property benefits. The foundation of that interest is the lack of an estate tax for the majority of taxpayers,

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215. Lee, *supra* note 168, at 21–22.

216. *Id.* at 22.

217. 26 U.S.C. § 2038(a)(1) (2012).

combined with the preferential double basis adjustment at the death of the first spouse.<sup>218</sup> Moreover, techniques are being developed to create community property-like treatment in common law states. For example, the JEST attempts to provide married couples residing in non-community property states some of the same basis step-up enjoyed by couples that pass away with community property under I.R.C. § 1014(b)(6). Because there is both proven elasticity to the estate tax rate and observed responsiveness, there is real need to reexamine the estate tax.<sup>219</sup> But before changes can be proposed, an examination of the income tax must occur. This is because the actual asset blends of taxpayers show that the basis step-up disproportionately affects the wealthy while being neutral to negative for others.

### III. MODERN WEALTH THEORY

Most examinations of the estate tax fail to look at the income tax effects associated with the basis step-up.<sup>220</sup> Moreover, even if that is factored into the overall rate effect, a final component is still missing. It is not just the fact that the estate tax raises basis that affects the income tax rate, but also the tax preferences built into the income tax code relating to the type of asset that actually exacerbates the differential in conventional analysis. The missing piece, introduced by this article, is to look at the effect of the basis step-up, estate tax paid, and income tax effect on actual portfolios of the differing wealth strata.

Unfortunately, today we tend to look at wealth as the total assets of individuals. Much like when, in the 1950s, we moved to think of the portfolio holistically, we should move to think about wealth more holistically today. I would like to introduce what I term “Modern Wealth Theory” to be used as the model for estate and income tax. Modern Wealth Theory would look at wealth in both the dimensions of total assets and asset composition. In this way, the effects of the income and estate taxes can be properly calibrated to assure that policy goals are achieved under the appropriate tax.

Modern Portfolio Theory is a theory of finance, developed by Harry

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218. See Lee, *supra* note 168, at 10.

219. See Auten & Joulfaian, *supra* note 22, at 226–27; Poterba & Weisbenner, *supra* note 138, at 422–55. See generally Robert B. Avery, Daniel Grodzicki & Kevin B. Moore, *Estate vs. Capital Gains Taxation: An Evaluation of Prospective Policies for Taxing Wealth at the Time of Death* (Fed. Reserve Bd., Fin. and Econ. Discussion Series Working Paper No. 2013-28, 2013), <http://www.federalreserve.gov/pubs/feds/2013/201328/201328pap.pdf>;

220. See *supra* notes 113–19.

Markowitz in the 1950s, that attempts to maximize a portfolio return.<sup>221</sup> Prior to this outlook, individuals would look to individual assets for performance. If newspapers were providing good returns, investors would place all their assets in newspapers. Now we would call that a high-risk investment because it exhibits firm-specific risk. Even if the investor bought multiple newspapers and radio stations, the risk still would not be diversified because it has single-sector risk. Modern Portfolio Theory entered to look at a portfolio holistically and show that through diversification, individuals could attain greater returns than by taking a single position.<sup>222</sup>

For example, the single model of an estate tax that has been built since 1980 is based on the assumption that taxpayers desire to utilize the income tax step-up at the expense of the estate tax. Through this lens, the estate tax appears to be a tool to an end. When this tool is then used to hurt family farms and small businesses it becomes toxic. But the redistributive model of the initial estate tax has, for all practical purposes, been abandoned.

The abandonment of the progressive ideals behind the estate tax is problematic, as progressive taxation has throughout history limited the concentration of income and wealth. Currently, America is undergoing a new version of the Roaring Twenties.<sup>223</sup> High-income households pay much lower effective tax rates than ever before.<sup>224</sup>

In order to use tax to address contemporary income and wealth inequality, various buy-ins need to occur: (1) that the underlying rationales for progressivity exist, and this problem can be solved by a progressive tax; (2) that given the need for a tax, strata of divisions must be agreed; and (3) that with the dual problem of income and wealth concentration, an examination of those divisions is necessary in a multi-dimensional setting of income or wealth levels, asset compositions, and applicability of both estate and income taxes.

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221. Harry M. Markowitz, *Foundations of Portfolio Theory*, 46 J. FIN. 469, 469–70 (1991); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 711–13 (1982).

222. See generally Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1992).

223. See Justin Wolfers, *Talk Turns to Inequality at Annual Meeting of Economists*, N.Y. TIMES: UPSHOT (Jan. 5, 2015), <https://www.nytimes.com/2015/01/06/upshot/renewed-interest-in-inequality-at-annual-meeting-of-economists-.html>.

224. Chuck Marr & Nathaniel Frentz, *Federal Income Taxes on Middle-Income Families Remain Near Historic Lows*, CTR. ON BUDGET & POL'Y PRIORITIES (Apr. 15, 2014), <http://www.cbpp.org/cms/?fa=view&id=3151>.

## A. A PROGRESSIVE MARKETPLACE

The first estate taxes, as with the origins of most taxes, were a pure revenue measure, implemented only in times of war or financial crisis. By the time progressives like Teddy Roosevelt were in the White House, however, the estate tax was viewed as more than a means to generate revenue. As Roosevelt told Congress in 1906, “the prime object should be to put a constantly increasing burden on the inheritance of those swollen fortunes which it is certainly of no benefit to this country to perpetuate.”<sup>225</sup>

When today’s economy is compared to that of 1932, the parallels are striking. The 1920s had, much like today, resulted in a markedly unequal distribution of wealth. The top end was growing at the expense of the bottom. “Between 1921 and 1928, the number of Americans with annual incomes over \$1,000,000 increased from 21 to 511, while the number earning between \$500,000 and \$1,000,000 annually increased from 63 to 983.”<sup>226</sup> The response to this concentration of wealth, deemed dangerous for society, was the largely progressive estate tax.

Today, we are in the midst of recovery from a financial crisis similar to the Great Depression.<sup>227</sup> During this recovery, authors such as Thomas Piketty have emerged to study the effects of similar concentrations of wealth on the overall well-being of the economy. Just like in the Roaring Twenties, the overextended 2000s saw outrageous bets in the marketplace and blame directed at the top economic tier for excessive risk-taking. During the recovery from the crash that then followed, there has been a push among economists to attempt to quantify where the losses came from. Thus far, it appears that much like the actual results from the 1920s, the losses were merely a shift of wealth from the lower wealth tiers to the top of the top wealth tier, illustrated in Table 1. This opens a door to again introduce a similar solution, based on progressive ideals.

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225. 41 CONG. REC. 28 (1906) (statement of President Roosevelt).

226. Cooper, *supra* note 24, at 885.

227. See generally RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF ‘08 AND THE DESCENT INTO DEPRESSION (2009); Vincent S.J. Buccola, *An Ex Ante Approach to Excessive State Debt*, 64 DUKE L.J. 235 (2014); David J. Herzig, *Review of Current Scholarship on the Fiscal Cliff*, 47 IND. L. REV. 185 (2014); Andrew Ross Sorkin, *A Bailout Above the Law*, N.Y. TIMES (Sept 22, 2008), <http://www.nytimes.com/2008/09/23/business/23sorkin.html>.

TABLE 1. Wealth of U.S. Households Before and After the Great Recession

	2003	2007	2009	2013
Mean	\$337,233	\$423,592	\$411,178	\$308,276
Percentiles				
5th	-9,749	-13,482	-27,689	-27,416
25th	10,129	6,966	2,723	3,200
50th (median)	87,992	98,872	70,801	56,335
75th	302,221	367,959	302,412	260,405
90th	736,853	934,223	819,824	763,099
95th	1,192,639	1,629,133	1,420,304	1,364,834

Note: Fabian T. Pfeffer, Sheldon Danziger & Robert F. Schoeni, *Wealth Levels, Wealth Inequality, and the Great Recession: Research Summary 1* tbl.1 (Russell Sage Fdn. Working Paper, 2014). All figures are given in 2013 dollars.

Why *not* progressivity? Some argue for instruments other than progressivity, or else merely changes to the rates, to solve the problem.<sup>228</sup> Some argue the assumptions of Piketty and others are wrong or misplaced.<sup>229</sup> Although both arguments have salience as counters, neither is particularly strong if distributive justice is a concern. Moreover, under the current system, the result of the tax is regressive, which has little support among the public.<sup>230</sup>

The most dominant tax counter to progressivity is that rates—not more instruments—of taxation should be the tool. One of the current dominant themes in public-finance literature is the elimination of tax on income and wealth and a replacement with flat, proportional, or consumption taxes.<sup>231</sup> However, few support a regressive tax regime where

228. See generally David Gamage, *How Should Governments Promote Distributive Justice?: A Framework for Analyzing the Optimal Choice of Tax Instruments*, 68 TAX L. REV. 1 (2014). See also Fleischer, *supra* note 3, at 77–80; Alex Raskolnikov, *Accepting the Limits of Tax Law and Economics*, 98 CORNELL L. REV. 523, 582–85 (2013).

229. But this research has a number of methodological drawbacks previously addressed in the academic literature by Alan Reynolds of the Cato Institute and others. See, e.g., ALAN REYNOLDS, *INCOME AND WEALTH* 40–44 (2006).

230. See, e.g., Frank Newport, *Majority Say Wealthy Americans, Corporations Taxed Too Little*, GALLUP NEWS (Apr. 18, 2017), <http://news.gallup.com/poll/208685/majority-say-wealthy-americans-corporations-taxed-little.aspx>.

231. See Fleischer, *supra* note 3, at 77; Gamage, *supra* note 228, at 1–3; Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, 24–25 (1992).

rates would fall as income rises.<sup>232</sup> And in the area of founders' stock, like carried interest, loopholes that allow a rate of 15 percent or zero do not gain traction even for proponents of the flat or proportional tax.<sup>233</sup>

This counter is especially salient because the dominant view is that the best manner to address distributive justice problems is by setting tax rates.<sup>234</sup> Modern public-finance theory normally would argue that a more robust tax on both wealth and income would support elimination of the double-distortion. This is because rates should be the mechanism, and distributive justice should not be in play. Therefore, governments should tax neither income nor wealth but deal with revenue through consumption taxes.<sup>235</sup>

Recently, there has been a meaningful reexamination of the use of policy instruments to not only raise rates but also achieve the progressive ideals that are the foundation of the estate tax. Counter to the dominant view, governments have a "greater capacity to raise revenues and to promote distributional equity at lower efficiency costs than is generally recognized."<sup>236</sup> It is much harder to game both the income and estate taxes simultaneously. As evidence of the difficulty in gaming multiple instruments, practitioners are having a rather difficult time achieving Pareto results under the ATRA, the double basis step-up, and the income tax distortions.

Moreover, ultimately, taxation is, *ex post*, a much better public policy instrument to address inequality. Many economists believe that as compared with *ex ante* changes in legal rules, taxation is better for this purpose.<sup>237</sup> Whether Piketty's proposal for a global wealth tax is the ultimate solution, it nonetheless addresses the core benefit of taxation.<sup>238</sup>

The current problem with the estate tax is the single dimension in which the tax is viewed and discussed. The sole metric for measuring the estate tax is by net worth. Even assuming that this is a good measurement

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232. Fleischer, *supra* note 3, at 77.

233. *Id.* at 64–66.

234. Gamage, *supra* note 228, at 3.

235. *See id.* at 1–6; Daniel Shaviro, *Beyond the Pro-Consumption Tax Consensus*, 60 STAN. L. REV. 745, 746–48 (2007).

236. Gamage, *supra* note 228, at 65.

237. David Singh Grewal, *The Laws of Capitalism*, 128 HARV. L. REV. 626, 664–65 (2014) (reviewing THOMAS PIKETTY, *CAPITAL IN THE TWENTY-FIRST CENTURY* (2014)).

238. *Id.* ("Piketty's proposal for a global wealth tax assumes a coordinated, top-down, data-driven, and retrospective response to the inequalities that capitalism generates—and in this he globalizes the familiar presumption of many economists that taxation *ex post* is a better way to address inequality than *ex ante* changes to the legal rules governing the economy.")

of determining wealth, it is incomplete. Although scholars generally shun the concept of taxing utility and opportunity, wealth has significant mobility implications, from a correlation with future earning potential to SAT scores.<sup>239</sup> I do not suggest that we tax these unconventional, although wholly potential, sources of revenue. Rather, my examination of the measure of wealth to be taxed should include two other dimensions: first, the income tax effect, and second, the asset blend subject to income tax preferences.

#### B. INCOME TAX EFFECT

The incomes of the top 10 percent have risen sharply since 1980, with the largest gains for the upper 1 percent.<sup>240</sup> Assuming that there are substantive positive law rationales for the use of taxation to address the income and wealth inequalities that I assume exist, it is important to examine the dual impact of the estate and income taxes. Not only are the rationales for the expansion of the tax effect at the expense of the tax base lacking, but also, the theoretical beneficiaries of the modifications are not obtaining a benefit.

The essential frame of the issue on the interrelationship between the income tax and estate tax is as follows: we must not tax assets on death because it would amount to double taxation, which is perceived as unfair.<sup>241</sup> However, if those assets are avoiding taxation, then failing to tax those assets defeats progressivity.

Thus, the pertinent income tax question is: to what extent are assets either being taxed twice or not at all? Piketty and others claim that the majority of assets are avoiding taxation entirely. In a recent study at the Federal Reserve, the majority of large estates were comprised of untaxed assets from appreciation.<sup>242</sup> “We estimate that the average unrealized capital gains in estates monotonically increases with the size of the estate, ranging from 13% for estates under \$2 million to 55% for estates over \$100 million.”<sup>243</sup>

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239. See, e.g., Josh Zumbrun, *SAT Scores and Income Inequality: How Wealthier Kids Rank Higher*, WALL ST. J.: REAL TIME ECON. (Oct. 7, 2014, 5:29 PM), <http://blogs.wsj.com/economics/2014/10/07/sat-scores-and-income-inequality-how-wealthier-kids-rank-higher/>.

240. See Avery et al., *supra* note 219, at 4–6; Chad Stone et al., *A Guide to Statistics on Historical Trends in Income Inequality*, CTR. ON BUDGET & POL’Y PRIORITIES (Nov. 7, 2016), <https://www.cbpp.org/research/poverty-and-inequality/a-guide-to-statistics-on-historical-trends-in-income-inequality>.

241. Avery et al., *supra* note 219, at 3.

242. *Id.* at 18, 31 fig.1.

243. *Id.* at 2.

As discussed before, it is complicated to show elasticity between the income and estate taxes.<sup>244</sup> For example, as good of a job as the Federal Reserve study attempts to do, the study has problems in data collection, and it ignores the community property double basis step-up problem.<sup>245</sup> There seem to be too many variables to have a clear study. But we have observational data that is more persuasive than the empirical data. Taxpayers show responsiveness to the estate and income tax rates through the transactions discussed in the literature.<sup>246</sup>

There are studies besides the Federal Reserve's that do show a positive elasticity between income tax, capital gains realizations, and the estate tax. In 2001, studies by Auten and Joulfaian and Poterba and Weisbenner demonstrated taxpayer distortions.<sup>247</sup> The Auten and Joulfaian study found that a 1 percent increase in the tax rate increases realizations prior to death by 0.36%.<sup>248</sup> This appears to suggest that low estate tax rates compound the income tax gaming that practitioners are advocating. Moreover, this study substantiates the locked-in effect that is a suggested outcome of the stepped-up basis.

There is not only elasticity between the income and estate tax, but also a need for progressivity. This is especially true given not only the basis step up, but also the actual asset blends held by taxpayers. Most current literature only focuses on the former problem.<sup>249</sup> Here, I will introduce the later problem to demonstrate that even without income tax considerations resulting from basis step-up, the asset blends of taxpayers create substantial benefits for wealthy taxpayers, and without basis step-up, lower-wealth taxpayers can achieve the same non-tax economic position through the operation of the income tax.

### C. ASSET BLEND

The estate tax fails to take into account the blend of assets. This is because the real question is not the total number of assets people have but rather the composition of those assets, as the primary driver of income

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244. *Id.* at 7.

245. *See* Avery et al., *supra* note 219, at 11–13.

246. *See* Poterba & Weisbenner, *supra* note 138, at 422–26.

247. *See generally id.*; Auten & Joulfaian, *supra* note 22. The Poterba and Weisbenner study concludes, in Avery's description, that "a capital gains tax imposed at death raises less total revenue than the estate tax. Households with estates under \$1 million would pay more under a capital gains tax, while households with larger estates would be more likely to experience a substantial reduction in tax liability under a capital gains tax." Avery et al., *supra* note 219, at 7.

248. Auten & Joulfaian, *supra* note 22, at 221–24.

249. *See, e.g.,* Avery et al., *supra* note 219, at 7.

growth at the top combines both increases in capital income, like returns on investments, with rising salaries. When the combined tax effects of the ATRA are taken into account, not only are few estates paying tax, but also those estates do not need the relief.

Once we start to untangle the composition of assets held by the new “working rich,” a more complete picture of the failure of the estate tax emerges. For example, the top 1 percent holds 74% of their assets in private businesses, real estate (excluding personal residences), and stocks (private businesses, real estate, and stocks will be collectively referred to as “PRS Assets”); only 9% of their wealth in personal residences.<sup>250</sup> On the other hand, the next 19 percent of the population holds 40% of their assets in the PRS Assets and 28% in their homes, while the middle 60 percent has a blend of 12% PRS Assets and 63% in homes.<sup>251</sup> (Part of the top 1 percent is in the “working rich” category, as well as a portion of the 19 percent.)<sup>252</sup> When the estate tax is examined at its current exemption amount, not as redistribution tool but as a free income tax benefit to the “working rich,” it is easy to see how badly the estate tax is doing its job.

From an income tax perspective, the basis step up is vastly more important to the “working rich” than to the bottom 80 percent. Since the largest asset the bottom 80 percent hold is real estate, and by definition they have less than \$400,000 in assets, most likely there would be little to no income tax advantage from having a basis step-up at death. The combination of no estate tax plus the step-up in basis only matters when there are enough assets in the estate to use the tax-free basis step up.

The next 19 percent, those with assets over \$3.5 million but under \$7.8 million, are now under the ATRA exempt from estate tax and receive full basis step-up from an income tax perspective. This is an exponentially larger benefit. Since only 28% of their worth is in the home, there is a larger benefit to the step-up in basis. For example, using an example of a couple with \$5,000,000 of net worth, under the assumed portfolio, this \$5,000,000 would be comprised of \$1,200,000 in business entities and non-residential real estate equity, \$800,000 in financial securities, \$1,100,000

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250. See Edward N. Wolff, *Household Wealth Trends in the United States, 1962–2013: What Happened Over the Great Recession?* 54 tbl.5 (Nat’l Bureau of Econ. Research, Working Paper No. 20733, 2014), <http://www.nber.org/papers/w20733>.

251. *Id.*

252. Cf. Robert Frank, *How Many of the Rich Actually Work for a Living?*, WALL ST. J.: WEALTH REP. (Dec. 1, 2010, 1:10 PM), <https://blogs.wsj.com/wealth/2010/12/01/how-many-of-the-rich-actually-work-for-a-living>.

in pensions, \$500,000 in liquid and other, and \$1,400,000 in a house.

With ATRA, that couple has no estate tax and a basis step-up, or double basis step-up if in a community property jurisdiction, at the death of the second spouse. This means that there would be no income tax gain, either, for the sale of these assets. If there was no estate tax, the home alone would be subject to tax on the sale of \$800,000, while the other assets would still be subject to capital gains rates. If there were an estate tax at EGTRRA levels, then the couple would have an estate tax of \$1,500,000 and would not be able to protect all of their net worth at death.

The fundamental problem with the ATRA from an inequality standpoint is that it captures part of the top 1 percent and a large portion of the next 19 percent of wealth and allows not only estate tax savings, but also substantial income tax savings for those taxpayers. There is no benefit to the lower 80 percent of taxpayers; in fact, this higher tax rate might further the law of mobility that Gregory Clark and Raj Chetty and others speak of.<sup>253</sup> If you then add the potential double basis step-up in community property jurisdictions to the mix, a serious reexamination of the estate tax should be taking place.

Under most assumptions, wealth does not focus solely on assets, but also on income. “Upper income” taxpayers made \$639,000 on average in 2013. Does this income amount necessarily correlate with a net worth over \$10,000,000? There is no current empirical data linking the two. However, there are certainly circumstantial inferences that can be made. “Upper income” taxpayers have steadily increased the gap between them and the “middle income” taxpayer; it was reported in 2014 as 6.6 times bigger.<sup>254</sup> That is up from a 6.2 multiple in 2010.<sup>255</sup> What if wealth is not based on only one measure, for example, net worth, but also a second, earnings? If we begin to take into account current earnings, not just savings and inherited wealth, then we can see how the current incarnation of the estate tax is actually not fulfilling its primary redistribution goal. The secondary basis step-up problem is causing, in my opinion, a widening of the gap between the bands. The lack of any estate tax combined with the lack of

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253. See generally, e.g., GREGORY CLARK, *THE SON ALSO RISES: SURNAMES AND THE HISTORY OF SOCIAL MOBILITY* (2014). See also Raj Chetty et al., *Where is the Land of Opportunity? The Geography of Intergenerational Mobility in the United States* 42–45 (Nat'l Bureau of Econ. Research, Working Paper No. 19843, 2014), <http://www.nber.org/papers/w19843>.

254. Neil Shah, *Wealth Gap Between America's Rich and Middle-Class Families Widest on Record*, WALL ST. J.: REAL TIME ECON. (Dec. 17, 2014, 11:15 AM), <https://blogs.wsj.com/economics/2014/12/17/wealth-gap-between-americas-rich-and-middle-class-families-widest-on-record>.

255. *Id.*

income tax is problematic, since the estate tax exemption amount has begun to bleed into the top 1 percent. If the conventional assumption is correct that the purpose of the estate tax is to redistribute wealth, in this new paradigm it fails to accomplish that goal.

#### IV. ELIMINATE THE ESTATE TAX

Tax progressivity has an especially strong influence on the structure of inequality in market economies.<sup>256</sup> Recently, progressivity has declined both in terms of the percentage of total revenue paid in taxes as well as in relation to GDP.<sup>257</sup> This has resulted in lower effective rates to high-income households.

I have made the case that much like the first Gilded Age, this, our second Gilded Age, requires the introduction of a progressive estate tax.<sup>258</sup> The concentration of capital has caused further striation between wealth and income levels. The normative question, then, is which policy approach would yield the most success in achieving a more balanced wealth distribution?

Piketty's answer to this normative question is a global wealth tax. His position is that ex post taxation is better than "ex ante changes to the legal rules governing the economy" to address inequality.<sup>259</sup> His belief is that market efficiency will then permit maximization of wealth during life, with the toll coming at death.<sup>260</sup> The identified problem with this approach is that by letting wealth accumulate unfettered during life, there is not much political capital left to tax the wealth at death, which is necessary for redistribution.<sup>261</sup> That is why Piketty identifies his global wealth taxation as

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256. See Mirko Bagaric & James McConvill, *Stop Taxing Happiness: A New Perspective on Progressive Taxation*, 2 PITT. TAX REV. 65, 87–88 (2005).

257. See generally William G. Gale & Andrew A. Samwick, *Effects of Income Tax Changes on Economic Growth* (Econ. Stud. at Brookings Paper, 2014), [https://www.brookings.edu/wp-content/uploads/2016/06/09\\_Effects\\_Income\\_Tax\\_Changes\\_Economic\\_Growth\\_Gale\\_Samwick.pdf](https://www.brookings.edu/wp-content/uploads/2016/06/09_Effects_Income_Tax_Changes_Economic_Growth_Gale_Samwick.pdf).

258. Hiroko Tabuchi, *Rushing to Cater to America's Rich*, N.Y. TIMES (Feb. 6, 2015), <https://www.nytimes.com/2015/02/07/business/makers-of-luxury-goods-shift-focus-to-united-states.html> (discussing America's second Gilded Age as shown through the luxury retail market).

259. Grewal, *supra* note 237, at 664–65 ("On that view, it is more efficient to allow the unencumbered market to generate wealth—which can later be redistributed—than to attempt to alter the organization of the market in the first place.").

260. *Id.*

261. Bill Bischoff, *Most State of the Union Tax Deals Are DOA*, MARKETWATCH (Jan. 21, 2015, 3:45 PM), <http://on.mktw.net/1yI4rCb>. See also Jordan Weissmann, *Obama's State of the Union Agenda: Progressivism on the Cheap*, SLATE (Jan. 20, 2015, 8:53 AM), [http://www.slate.com/blogs/moneybox/2015/01/20/state\\_of\\_the\\_union\\_2015\\_obama\\_s\\_new\\_economic\\_agenda\\_is\\_progressivism\\_on.html](http://www.slate.com/blogs/moneybox/2015/01/20/state_of_the_union_2015_obama_s_new_economic_agenda_is_progressivism_on.html).

“utopian.”<sup>262</sup> Piketty’s single-instrument approach is neither politically viable nor the best choice. In this section, I will address the various choices, starting with the ideal readjustment of the estate tax, and then moving to the second-best choices, including adjustments merely on rates or exemption levels and the elimination of the estate tax with carryover basis.

#### A. DUAL-INSTRUMENT APPROACH

Decades of tax exemptions, deductions, and exclusions have effectively reduced effective tax rates on high-income households. The tax exemptions have sheltered significant amounts of income and wealth from normal taxation.<sup>263</sup> Moreover, there is elasticity between the income and estate taxes; a dual-instrument approach would appear to have the best chance of success. The Federal Reserve study showed that “policies aimed at taxing the entire estate raise more revenue than those aimed at taxing unrealized gains.”<sup>264</sup> Thus, manipulating both the income tax and the estate tax would achieve the highest level of progressivity.

In 2015, much like in 1932, the largest taxable estates generated the majority of estate tax revenues.<sup>265</sup> Also much like in 1932, an attempt to broaden the base of estate taxation through modest reductions in the estate tax exemption would only add to compliance burdens with little revenue. The Revenue Act of 1932 did not merely target the wealthy. “When viewed in relative terms, the impact on smaller estates was far more pronounced than that on larger estates. For example, in the case of a \$150,000 net estate, the tax increased by a full order of magnitude, from \$500 before the Revenue Act of 1932 to \$5,000 thereafter.”<sup>266</sup>

The problem with just a 1932-like resolution is that a mere random exemption reduction would not correlate with increased revenue. For example, the Revenue Act of 1932 reduced the exemption from \$100,000 to \$50,000. But given the results of the first Gilded Age, merely retaining the exemption at \$100,000 would have reduced the annual returns by 55 percent while retaining about 95 percent of the revenue.<sup>267</sup>

The current large gap between wealth strata creates a similar problem

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262. THOMAS PIKETTY, *CAPITAL IN THE TWENTY-FIRST CENTURY* 515 (2014). *See also* Grewal, *supra* note 237, at 665–66 (“[I]t is because it presumes a political agent capable of enacting it, which is neither present now nor likely to be generated by the trends he identifies.”).

263. Gamage, *supra* note 228, at 2.

264. Avery, et al., *supra* note 219, at 2.

265. *See* Huang & Cho, *supra* note 7.

266. Cooper, *supra* note 24, at 898.

267. *Id.* at 901–02.

today. Even holding revenue raising as a neutral category, a progressive estate tax not only broadens the base but also increases the rate. Unlike with base expansion, the view that raising rates will only have marginal revenue impacts with increased compliance costs is misplaced. What is useful about the 1932 experiment is that it may be helpful in efficiently calibrating the estate tax rates so that redistribution will occur.

The ideal tax would create income and estate taxes that address the Modern Wealth Theory. Through a piecemeal attack, both the base and the rate have dramatically shrunk since 1980. A revised estate tax would address the concentration of wealth, while a revised income tax would address a more optimal tax regime representing the asset composition of taxpayers. The only question that would need to be addressed is how best to calibrate the rate and the base. A thorough study would need to be done to establish the rate and base before a recommendation could be made.

The second-best approach to addressing the problem from the dual-instrument approach is to retain the income tax, and possibly address rates in that dimension, while eliminating the estate tax and instituting carryover basis. Initially, it may seem counter-intuitive that the second-best answer is to eliminate the tax rather than to retain the tax with higher rates. Raising rates will be addressed in the next section, but for now, raising rates would merely address progressivity at the expense of deadweight loss.<sup>268</sup> Essentially, as we saw in 1976, the most efficient way to address concentrated wealth is to eliminate the step-up basis rules. The Federal Reserve study estimated “unrealized capital gains represent 55 percent of the total value of estates worth more than \$100 million.”<sup>269</sup> By eliminating this rule, which shelters income tax for the working rich, the effective tax rates would rise. This has the dual benefit of making the code more progressive while also reducing the tax planning associated with the basis step-up.

To the extent that the CBO and the Federal Reserve have studied this, the impact is staggering. The CBO estimates that the basis step-up rule will reduce federal revenues by \$644 billion over ten years.<sup>270</sup> Not only will revenue go down, but also the subsidy—estimated at 21 percent—will go

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268. Lee Anne Fennell, *Death, Taxes, and Cognition*, 81 N.C. L. REV. 567, 635–647 (2003); Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L.J. 283, 336 (1994).

269. HARRY STEIN, CTR. FOR AM. PROGRESS, HOW THE GOVERNMENT SUBSIDIZES WEALTH INEQUALITY 7 (2014) <http://cdn.americanprogress.org/wp-content/uploads/2014/06/WealthInequality.pdf>. (citing Avery et al., *supra* note 219, at 18).

270. CONGRESSIONAL BUDGET OFFICE, *supra* note 21, at 6 tbl.1; STEIN, *supra* note 269, at 6, 8.

to the top 1 percent.<sup>271</sup> The result of the operation of the current dual-instrument approach is that more than half the accumulated wealth of the wealthiest estates is “never subject to income taxes.”<sup>272</sup>

If there is resistance to properly calibrating the current dual-instrument approach, then the next-best solution is to either treat death as a realization event with no step-up, or just have no step-up and no tax. The realization event proposal has had more traction recently with a Federal Reserve study and a proposal by the president, so it will be addressed first. The elimination of the basis step-up with no corresponding estate tax is a second-best alternative recently in place in 2010 and studied extensively in 1976.

#### B. DEATH AS A REALIZATION EVENT

The Federal Reserve study compared three outcomes: (1) rolling the exemption back to \$1 million and raising rates to 55 percent (approximately the 2001 law); (2) rolling the exemption back to \$3.5 million and keeping rates at 45 percent (approximately the 2009 law); and (3) no estate tax but treating death as a realization event.<sup>273</sup> As an initial matter, it would have been useful to have a meaningful baseline of no tax. The Federal Reserve approach is designed to attempt to deal with the Modern Wealth Portfolio analysis I describe here. The test tried to quantify the impact of the basis step-up.

The study found that:

[I]f death is treated as a capital gains realization with no step-up basis and other estate taxes are eliminated, the amount of tax revenue generated between 2013 and 2023 is \$561 billion. This is similar to that generated by the 2009 estate tax law scenario (\$529 billion) but less than that generated by the 2001 law scenario (\$1.2 trillion) over the same period.<sup>274</sup>

But more importantly, more taxpayers would be affected by the tax. In the study, almost 75 percent of decedents would be subject to the capital gains taxation, compared to either about 5 percent under the 2009 law or about 15 percent under the 2001 law.<sup>275</sup> This shift substantially changes the makeup of the taxpaying demographic. Thus, the study, at least partially,

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271. CONGRESSIONAL BUDGET OFFICE, *supra* note 21, at 16.

272. STEIN, *supra* note 269, at 7.

273. Avery et al., *supra* note 219, at 9–10.

274. *Id.* at 5.

275. *Id.*

examines the impact on the new wealth holders.<sup>276</sup>

As stated previously, more wealth correlates with more capital assets. The asset blend of the bottom 80 percent is mostly homes and retirement accounts, which, although subject to capital gains taxation, have independent income tax subsidies.<sup>277</sup> Using the death-as-a-realization-event model, the Federal Reserve estimates that “91.6 percent of the tax is paid by the top 1 percent of wealth holders, an increase of 10 percentage points over the 2009 law, and a still larger increase over the other scenarios considered.”<sup>278</sup> The effect, according to the Federal Reserve, of using death, as a realization event is a reduction of the total amount of tax raised.<sup>279</sup> The benefit of using death as a realization event is not that it raises the revenue but that it “concentrates the remaining burden more among high wealth holders.”<sup>280</sup> As a tool to insert progressivity back into the system, there should be a required tax at death.

The consequences of taxing assets at death are the theoretical second-order problems of the locked-in effect and the tax preferences, e.g., like-kind exchanges. The forced breakup of wealth needed to smooth the inequality problem can use this single-instrument approach to try to solve the second-order problems.<sup>281</sup> It would also stop the distortions caused by the existing system.

The single most important advantage of the movement to a single-instrument approach, with death as a realization event, is that any preferences can be built into the income tax code without regard for the distortive effects of the estate tax. For example, the most common argument for raising the exemption amount has been to safeguard family farms and small businesses. Under the Federal Reserve study, however, the impact varied across the various demographics.<sup>282</sup> “For farm business owners, mean tax liability is higher under the 2009 estate tax law and step-up basis proposals, but the share of tax liability is highest under the no step-up basis proposal.”<sup>283</sup> The results seemed consistent for the small, non-farm business owners, with the exception of a higher tax liability share:

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276. *See id.* at 5–6.

277. *See supra* note 250 and accompanying text.

278. Avery et al., *supra* note 219, at 5–6.

279. *Id.* at 5. This is primarily because of the current capital gains rates. If rates go up, obviously, the amount of tax can also increase.

280. *Id.* at 6.

281. *See id.* at 22.

282. *Id.*

283. *Id.*

Large non-farm business owners have the highest mean tax liability of any group under the 2009 estate tax law and the step-up basis proposal . . . the share of tax liability accounted for by this group is higher under the capital gains scenarios, reflecting the large share of unrealized gains in their gross estate.<sup>284</sup>

The numbers would then support the common 1980s narrative that the tax is detrimental to farms and business. However, the advantage of the single-instrument approach is that effects can be directly measured, instead of inferred under the dual-instrument approach, and then addressed through income tax preferences. The income tax rules could exempt family farms or small businesses from the realization event or make the gain subject to a § 1031-like non-recognition rule. The additional benefit of dealing with capital gains in family farms and businesses in the income tax is that the effects can be calibrated, as they need to be over time, with clear and measurable results.

Moreover, without basis step-up and the forgiveness of capital gains at death, the locked-in effect should be mitigated.<sup>285</sup> Because there would no longer be an incentive to die with highly appreciated assets, these assets should be more freely traded during life. This will have the two-fold benefit of both creating a more efficient marketplace for securities and smoothing the raising of revenues during the lifetime of taxpayers.

### C. ADDITIONAL ESTATE TAX ON APPRECIATION

Although the estate tax has been on the chopping block before, to date Congress has not considered modifications to the gift tax, or “enact[ing] an accessions tax.”<sup>286</sup> Therefore, the only tax instrument taking into account the untaxed appreciation of assets during life is the current estate tax.

This failure to tax accumulated appreciation during life represents deferred consumption:

But as this accumulation passes on it operates to create a kind of unearned original disparity in wealth in the hands of a new generation, which should be dealt with as such. Thus one comes to the conclusion that the way to make the tax system deal with disparities in wealth is by strengthening the gift and estate tax rather than through the income tax.<sup>287</sup>

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284. *Id.*

285. *See Zelenak, supra* note 9, at 372–73.

286. Gutman, *supra* note 10, at 1192.

287. William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1171–72 (1974).

If the best way to deal with the deferred consumption is through a strengthened estate tax, then an additional lever should be introduced to the estate tax to immediately address the deferred consumption.

In both 1968 and 1976, there was consideration given to a tax on the appreciated assets of the decedent in addition to the estate tax. Under this approach, assets would be treated as if sold by the decedent on the date of death, and any gain or loss would be reported on the final income tax return of the decedent.<sup>288</sup> Any losses would be eligible for carryback, and all gains would be treated as long term.<sup>289</sup> There were additional qualifications, since at the time there was still a dual-instrument approach. Thus, special rules were proposed to deal with the credits of the income tax against the estate tax and the marital and charitable deductions, and a threshold was set before any tax would be due.<sup>290</sup>

There was significant push back against retaining the dual instruments of the estate and income tax alongside the proposal.<sup>291</sup> The combination was thought to be regressive because the estate tax rate was about 75 percent at the time, and the capital gains rate was about 25 percent.<sup>292</sup> Since the majority of the assets of the high-end estates were appreciated assets, this proposal would effectively lower their rate while the lower-end estates would be paying the higher rate.<sup>293</sup> Combining this concern with the added complexity doomed the project.

The additional estate tax proposal that was most salient had a simple approach: a single flat tax on all appreciated assets at death or on transfers made within two years of the date of death.<sup>294</sup> There would be no modifications for marital or charitable deductions or other estate tax distortions or preferences.<sup>295</sup> This proposal was and is progressive because the appreciation is subject to both the estate and the income tax. Moreover, unlike a single income tax on appreciated assets at death, which may have constitutional problems, the additional estate tax is an excise tax free from those concerns.

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288. Richard B. Covey, *Possible Changes in the Basis Rule for Property Transferred by Gift or at Death*, 50 TAXES 831, 843 (1972).

289. *Id.* at 843.

290. *Id.*

291. See Graetz, *Evaluation*, *supra* note 9, at 832–35.

292. See *id.* at 836 n.22; *Historical Look at Estate and Gift Tax Rates*, Wolters Kluwer, <https://www.cchgroup.com/news-and-insights/wbot2017/historical-estate-gift-tax> (last visited Sept. 17, 2017) [hereinafter *Historical Look*].

293. *Cf.* Covey, *supra* note 288, at 834.

294. *Id.* at 843–44.

295. *Id.* at 844.

The additional estate tax does create the specter of double taxation. However, the progressive nature of the tax and the redistributive properties that the tax is designed to serve should offset this cost. Further, there are often double taxes imposed on the distribution of funds, for example, from company to shareholder in the form of a dividend.<sup>296</sup>

There would also need to be other compromises related to the community property double basis step-up. The solution to this would be an election by the surviving spouse to either subject the one-half of property to the additional estate tax or lose the step-up in basis.

Here is how the additional estate tax would work. Assume A and B each invested \$2 million, which has increased in value to \$20 million. If A sells during A's life (assume at a 28 percent rate), A would pay income tax of \$5,040,000 and have \$14,960,000 left in the estate. When A dies, the remaining amount would be subject to an estate tax (assume at a 45 percent rate), and there will be \$8,228,000 left for A's heirs. If B died still holding the assets and had no additional tax due, B would pay a tax of 45 percent on the \$20 million, leaving \$11 million for B's heirs.

To equalize A and B, the additional estate tax would have to be applied on the appreciation also. Here, that means that B would have to pay estate tax of \$900,000 on the \$2 million, and then an additional estate tax would need to apply to the appreciation of \$18 million. That means B would owe an additional estate tax of 60.4%, or \$10,872,000. If that were the case, B would have the same \$8,228,000 left to bequeath.

Since there is tax due, there should be basis adjustments made to increase the amount of tax paid. For example, where the property ends up in the marital or nonmarital share or in a charitable trust, necessary basis adjustments would need to take place.<sup>297</sup> There are simple ways to deal with the basis-allocation-related funding amounts. For example, it could be presumed that the assets used to fund the marital trust have the same basis-to-value ratio as the entire estate. Alternatively, a complicated formula could be employed to also take into account any changes on audits. Normally, taxpayers have a disdain for complicated formulas. However, in the field of estate and gift tax, complicated formulas are a part of life.<sup>298</sup>

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296. See I.R.C. § 1(h)(11) (2012).

297. See K. Jay Holdsworth et al., *Report on Transfer Tax Restructuring*, 41 TAX LAW. 395, 446-48 (1988).

298. See Covey, *supra* note 288, at 842; Zelenak, *supra* note 9, at 407-09.

## D. ADJUSTMENT OF RATES

The final choice—although the least salient, but working without a wholesale reform of the system—is to merely keep exemption amounts where they are but raise rates or drop exemptions. The real victory over the past thirty years has been the consistently lowered rate structure. The marginal utility of the moving exemption has not had as much of an effect as rates dropping to 45 percent. Although all the prior proscriptive solutions have the benefit of attacking both the income and the estate tax advantages in the current system, the system itself is not primed for a substantive shift in policy. For example, it has been argued that “policies that tax only gains concentrate a larger portion of the tax burden on high wealth households.”<sup>299</sup> If the prior solutions are long-term solutions, there is a stopgap that would involve little readjustment of the tax code or the rationales for the estate tax at its current ATRA levels. The most effective tax structure to break up wealth and raise revenue depends on rates and exemptions.<sup>300</sup>

If the exemption battle is lost for now, then the rate battle should be fought. However, the ideal rate is difficult to determine without significant input from all affected parties. But as a frame, the rate is ideally not a static number but rather a proxy to either federal revenues or GDP. For example, rates in the 1940s were between 70 and 77 percent, while since 1980 they have fluctuated generally downward towards about 40 percent.<sup>301</sup> When viewed within a frame of taxes (based on rate and exemption) as a percentage of federal revenues and GDP, the true distortive nature of today’s rates and exemptions are shown.

Looking at Table 2, in 1940, the 70 percent estate tax raised about 5 percent of total revenue and 0.3% of GDP. By 1985, the tax raised only 0.88% of revenue and 0.163% of GDP. By 2011, it was 0.3% of revenue and 0.05% of GDP.<sup>302</sup> If the exemption is to be retained at the current ATRA levels, then the rates need to be raised to achieve a proportionate share of burden on the top of the top 1 percent, both in terms of revenue

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299. Avery, et al., *supra* note 219, at 2.

300. As for the base, the current estate tax base is too small, as we are capturing a part of the top 1 percent. At a minimum, the base should be brought down to cover the top 20 percent. Thus, to begin we should start examining the base at the \$400,000 exemption level. *See also* Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 HARV. L. REV. 1177, 1189 (1978).

301. *See Historical Look, supra* note 292.

302. JOINT ECON. COMM. REPUBLICANS, REPUBLICAN STAFF STUDY: COST AND CONSEQUENCES OF THE FEDERAL ESTATE TAX: AN UPDATE 6 & fig.5 (2012), [http://www.jec.senate.gov/republicans/public/?a=Files.Serve&File\\_id=bc9424c1-8897-4dbd-b14c-a17c9c5380a3](http://www.jec.senate.gov/republicans/public/?a=Files.Serve&File_id=bc9424c1-8897-4dbd-b14c-a17c9c5380a3).

raising and as a percentage of the GDP.

TABLE 2. Gifts and Estate Tax Revenues, 1940-1990

<i>Year</i>	<i>Taxes Paid (millions)</i>	<i>% Federal Revenue</i>	<i>% GDP</i>
1940	\$353	5.39	0.366
1945	\$637	1.41	0.300
1950	\$698	1.77	0.262
1955	\$924	1.41	0.239
1960	\$1,606	1.74	0.318
1965	\$2,716	2.37	0.405
1970	\$3,644	1.89	0.369
1975	\$4,611	1.65	0.302
1980	\$6,389	1.24	0.240
1985	\$6,422	0.88	0.163
1990	\$11,500	1.12	0.213

*Note:* McCaffery, *supra* note 268, at 301 n.69.

There are two main triggers to deal with raising revenue. The first is through progression through the brackets. For example, one way to raise more revenue is to start rates at levels equal to the income tax and move to the top bracket at a much lower wealth level.<sup>303</sup> If we move through the brackets at a quicker rate, then much like the income tax, and even without exemption adjustment, progressivity will be introduced.

Movement through the brackets is an especially attractive tool when there have not been rate increases for a significant period of time. Currently, the progression through the rates is initially rather stark, then pedestrian for a long period of time.

The second manner of dealing with revenue raising is through adjusting the top bracket. What the top bracket should be is the most difficult question. In order to go back to raising about 0.40% of GDP, estate revenues would have needed to be \$671 billion in 2015.<sup>304</sup> Currently, the CBO expects the estate and gift taxes to together raise only \$260 billion

303. David Westfall, *Revitalizing the Federal Estate and Gift Taxes*, 83 HARV. L. REV. 986, 990 (1970).

304. 2016 GDP is estimated at approximately \$18.566 trillion. News Release, U.S. Chamber of Commerce, Bureau of Econ. Analysis, National Income and Product Accounts, Gross Domestic Product: Fourth Quarter and Annual 2016 8 tbl.3 (Feb. 28, 2017), [https://www.bea.gov/newsreleases/national/gdp/2017/pdf/gdp4q16\\_2nd.pdf](https://www.bea.gov/newsreleases/national/gdp/2017/pdf/gdp4q16_2nd.pdf).

over the entire period of 2017–2026.<sup>305</sup> Moreover, indexing to this percentage of GDP would also result in the estate tax generating approximately 5 percent of federal revenue, up from 1 percent.

Currently, at the low bracket rates, wealth is being concentrated at the top levels and not redistributed through either the tax system or charitable channels. In the 1940s, even if revenues were not the main targets, the high rates achieved some level of redistribution by encouraging charitable giving. If it was later determined that revenue was a necessary component of the estate tax, the charitable deduction could later be limited.<sup>306</sup>

The problem with the current rate structure is that taxpayers do not go through the brackets fast enough to even reach the top rate. Currently, it is estimated that the effective rate for the taxable estate is 16.6%.<sup>307</sup> That is far below the top 40 percent rate. In order to recalibrate the tax to 1940 levels and generate the appropriate portion of the tax burden, not only would the rate have to be raised significantly, but also the taxpayers would have to escalate through the rates faster.

#### E. CARRYOVER BASIS

The main problem with strengthening the estate tax in any one of the aforementioned ways is that there would be unnecessary tax at the lower levels. In 1976, there was careful study of the various choices; straight carryover basis was chosen.<sup>308</sup> At the time carryover basis was enacted, the rhetoric centered on the unworkability of the tax. Today, the concerns about the difficult nature and burdens of calculating the basis in assets just do not ring as true. The most efficient and progressive solution is to move to a carryover basis regime at death, with death acting as a realization event. The above remedial actions regarding income tax relief for various affected parties would be eliminated.

In 1976, the use of carryover basis, without treating death as a realization event, was premised by conceding that there would be an initial drop in estate tax revenues. From that position, revenues would be offset by

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305. See CONGRESSIONAL BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: 2016 TO 2026 95 tbl.4-1 (2016), <https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51129-2016outlookonecol-2.pdf>.

306. See Westfall, *supra* note 303, at 990.

307. Table T13-0020—Current Law Distribution of Gross Estate and New Estate Tax by Size of Gross Estate, 2013, TAX POL'Y CTR. (Jan. 9, 2013), <http://taxpolicycenter.org/numbers/displayatab.cfm?DocID=3776>. While the estimates have not been updated after 2013, the average effective estate tax rate should be very similar for 2014 and 2015 because the statutory rate remains the same and the exemption level is indexed to inflation.

308. See Graetz, *Evaluation*, *supra* note 9, at 832.

the new generation-skipping tax on trusts and the income tax on the assets acquired at death.<sup>309</sup> Movement away from this regime was at the time called a move “toward a basically sound and well-structured wealth transfer tax system.”<sup>310</sup> Unfortunately, Congress added the provisions of carryover basis in 1976, late in the process and without committee work. Because of this late introduction, it was harshly criticized “on both technical and policy grounds, and in 1980 it was repealed retroactively.”<sup>311</sup>

The problem with relying on the estate tax instrument solely is that the estate tax has “done very little to dilute the greatest concentrations of wealth. The portion of total wealth held by the richest one percent of wealth-holders has remained remarkably stable.”<sup>312</sup> Thus, by eliminating the estate tax and replacing it with one instrument, the income tax, an introduction of carryover basis would take place.

Although there has been strong advocating for carryover basis as a solution to the problem, there is more pushback against that technique. The advantage to carryover basis is that it would lessen the locked-in effect and put the taxing preferences into the income tax code. One of the most attractive benefits of carryover basis is that it relates more closely to the manner by which assets are currently taxed. Specifically, it imposes a tax when the asset is sold and the taxpayer thus most likely has the funds to pay the tax. This alleviates the main narrative against the estate tax.

The problems with carryover basis are well documented. There are both practical and theoretical problems that would exist. For example, carryover basis creates new problems for executors, because they have to take into account basis (and thus tax consequences) in distribution of assets.

But more importantly, without any tax consequences at death, theoretically permanent deferral would now be introduced.<sup>313</sup> This is especially true with the ability to borrow against stock through margin loans. Moreover, if there is more leveraging of the asset without taxation, then the locked-in effect could actually be exacerbated.<sup>314</sup> Also, the failure to generate any revenue at death is especially problematic if there is need for a reintroduction of progressivity to the code.

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309. Graetz, *Praise*, *supra* note 9, at 261 (citing H.R. REP. NO. 94-1380, 94th Cong., at 7 (1976)).

310. *Id.* at 262.

311. Zelenak, *supra* note 9, at 365.

312. Graetz, *Praise*, *supra* note 9, at 271.

313. Zelenak, *supra* note 9, at 363–64, 367.

314. *Id.* at 367.

## CONCLUSION

The most common argument for keeping the estate tax is that it is the most progressive tax.<sup>315</sup> The top 0.1 percent paid over half of all estate taxes, while the top 1 percent paid about 80 percent of all estate taxes.<sup>316</sup> The main problem with this argument, though, is that even though the current tax is hugely progressive and achieves arguably positive social benefits, it raises no real revenue and is highly inefficient. Yet because it only applies to the richest 1 percent, there is general public and political support for its retention. On the other hand, the most common argument for the elimination of the tax is that because it attacks the wealthy, it drives inefficient uses of resources. For example, in order to avoid the application of the tax, the wealthy spend on attorneys and planning instead of reinvesting in businesses.

Both of these arguments have been made since the early 1990s. Neither of these arguments has effectively shifted either policy or public opinion regarding the utility of the estate tax. What should happen? There are two real choices. First, eliminate the estate tax and just have carryover basis. Although this may seem like a non-progressive approach compared to the current estate tax regime, it at least addresses the separation between the top 19 percent and the bottom 80 percent. Currently, the estate tax/income tax double burden eliminates all built-in gain for these strata of taxpayers. Eliminating the current skewing of interests to obtain basis-step up at death would create an environment that should help lessen the widening of the income inequality. Further, we can deal with the redistribution of wealth better in the income tax. Examples can be seen as recently as 1997, when the rules for recognition of gains on the sale of homes changed from an unlimited amount to \$250,000 per taxpayer.<sup>317</sup> This change was a targeted income tax treatment for progressivity. The result of the elimination of the tax is almost nil on the fisc. The largest detriment to this position, however, is that the rich who would have owed estate tax—so there would have been a meaningful penalty associated with the basis step-up—would now go untaxed.

The ideal position would be to supplement the current dual-instrument approach by adding a third instrument, the wealth accumulation tax. Currently, taxpayers only pay estate taxes at an effective rate of about 16

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315. See, e.g., *Wealth Transfer Taxes: Who Pays the Estate Tax?*, TAX POL'Y CTR., <http://www.taxpolicycenter.org/briefing-book/key-elements/estate/who.cfm> (last visited Sept. 17, 2017).

316. *Id.*

317. Compare I.R.C. § 121(b) (2012), with I.R.C. § 1034 (1994) (repealed 1997).

percent. This is because the rules are ripe for gaming. Rather, than simplifying the rules by eliminating the estate tax and relying on the income tax, we should be adding instruments. It is much harder to game both the income and estate taxes simultaneously. It would be even harder to game a third instrument in the form of the wealth accumulation tax.

Regardless of the choice, retaining the tax as currently enacted exasperates inequality. If we want to deal with income inequality, then we need to address the fact that the top 19 percent—and even part of the top 1 percent—are not paying estate tax while also benefitting from huge income tax advantages. If you believe that there is a correlation between wealth and opportunity, then we must examine a tax that furthers the gap it was designed to narrow.