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The Dilemma of Married Couples Under the Gift and Estate Tax Laws: A Proposal

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THE DILEMMA OF MARRIED COUPLES UNDER THE GIFT AND ESTATE TAX LAWS: THE NEED FOR REFORM

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INTRODUCTION

For a considerable period of time there has been a concern, especially among lawyers who specialize in "estate planning," that the federal estate and gift tax laws[1] as they apply to transfers between married persons are unfair, unrealistic and operate to the disadvantage of those least able to afford them.[2] During the past one and one-half decades, changes in economic conditions have brought more people under these laws. Since there have been no corresponding amendments to the laws, these changing conditions have aggravated the wrongs which stem from the faulty philosophical premises of the laws. Publicity of the need for estate planning, such as articles in two recent issues of a widely circulated magazine which is well-regarded for its ability to explain important and technical concepts in practical and nontechnical terms,[3] has alerted many to the problems and has caused them to seek competent advice; but this simply is not enough. Now there are proposals to reform the laws in ways which appear to recognize, and are much more closely aligned to, modern circumstances and the realities of our society today. The purpose of this article is to illustrate the problems under the present laws and to examine and comment on the proposed reforms.

AN ILLUSTRATION OF THE OPERATION OF PRESENT LAWS

Those features of the present federal estate and gift tax laws which I believe must be changed can best be illustrated by the use of two parallel examples. These involve one man whom we first view as a graduate engineering student in the final year of his pursuit of a masters degree and another, whom we first view as a third-year law student.

Joint Accounts with Money Earned by Only One

Both men were married shortly after they obtained their primary degrees and their wives taught school to support them while they

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1. INT. REV. CODE of 1954, § 2001 *et seq.* & § 2501 *et seq.* (respectively).
2. UNITED STATES DEP'T OF TREASURY, TAX REFORM STUDIES AND PROPOSALS 28-29, 111 (1968) [hereinafter cited as TAX REFORM STUDIES].
3. BETTER HOMES & GARDENS, Nov. 1968, at 65; BETTER HOMES & GARDENS, Jan. 1969, at 9.

completed their education. During the first year of their marriages most of their income was spent on establishing households and, of course, both families regarded their acquisitions as belonging to "them," not to the one who earned the money to make the purchases. In the second year, however, they found that they had enough extra money to establish savings accounts. When the engineering student opened an account, the bank teller suggested that he make it a joint account. He did so because it seemed natural to him and because it would simplify procedures during life and if either of them should die. When the law student opened an account, however, he had already been exposed to a knowledge of the vagaries of joint-and-survivorship ownership and he also anticipated the lifetime accumulation of an estate large enough that the federal estate tax law would be applicable; consequently he opened the account in his wife's name alone. He then arranged for the preparation of wills for him and his wife, by which each left all property to the other.

Commingling of Funds

As time passed, both men received their degrees and found employment with good organizations, the engineer with a major industry and the lawyer with a prestigious law firm. As is customary, the engineer was attracted to the company by a liberal wage and fringe benefit program, while the lawyer's initial compensation was small but grew quickly as he proved his ability. During the first three years after the men graduated, their wives continued to teach and their salaries, plus the amounts which the men were able to save, were invested in savings certificates, bonds and some stock. The engineer continued the pattern established while he was in school and deposited both salary checks in a joint checking account from which expenses were paid and against which checks were drawn when he added to their joint savings account and when he made investments. He registered all their investments in joint names and kept them in a safe deposit box which was registered in both their names. The lawyer, on the other hand, deposited his wife's salary checks in her savings account and from it made other investments which were registered in his wife's name. He deposited his own salary in a joint checking account, from which living expenses were paid, and the excess he deposited in his own savings account and invested in assets which were registered in his name alone. The attorney also kept accurate records and was careful to see that earnings on his wife's investments were placed in her account and those on his investments in his own account. After the wives left their teaching jobs, the men's salaries became the only source of income, and in each case they continued to follow the procedures they had previously established.

Life Insurance

When children were born, each man felt the need for life insurance and, although for a period of time it was necessary to do without certain things they would otherwise have bought, each was able to pay the substantial premiums necessary to provide sufficient insurance to protect their families. The engineer bought one policy, on which he paid the premiums from their joint checking account, and he designated his wife as the beneficiary. The lawyer found a company from which he could get two policies of equal size at a slightly greater cost than one policy and providing protection of the same aggregate amount. One of the policies was purchased by him, the other by his wife. Each paid the premiums on the policy owned by him or her from their separate accounts.

Gifts from Spouse to Spouse

Periodically, the lawyer would review their financial situation and, inasmuch as the value of his own assets exceeded the value of his wife's assets by a substantial amount, he would make gifts to her of cash or stock and would file gift tax returns if the size of the gifts made this necessary.

Wills

During this period the engineer and his wife had no wills, believing them to be unnecessary because all their property was owned jointly with right of survivorship. The lawyer had a will in which he utilized the estate tax marital deduction fully, providing that property in excess of any amount so deductible should be placed in trust for his wife; his wife's will placed all her property in a non-marital trust for his benefit.

Inheritances

After several years, both wives received a relatively substantial inheritance. The engineer's wife, taking a cue from his procedure, caused all that she thus acquired to be registered in both their names; but, of course, she did not file a gift tax return after doing so because she regarded the acquired property as "their" property. The lawyer insisted that his wife register all her property in her own name and, since this made their estates approximately equal in value, he changed his will to provide that all of his property would be placed in a trust for his wife.

Common Sense

It might be appropriate at this point to mention that as the lawyer followed the procedure just described, his wife would frequently question his advice because it seemed so foreign to their very happy marriage. The engineer's wife, of course, regarded the procedure they followed as entirely consonant with their happy marriage.

Estate Tax Results

Both men predeceased their wives by approximately ten years. The engineer's tax return showed savings accounts, real estate, stocks and bonds which were jointly owned by him and his wife and life insurance which he owned but the proceeds of which were to be paid to his wife. The aggregate value of these assets, less debts and last expenses, was $160,000. The estate tax, after the marital deduction was taken, was only $1600, but during the rest of her life his wife was able to live on just the income from the property. The estate tax on that same property upon her death was $20,700, a total tax on both estates of $22,300.

The combined estates of the lawyer and his wife were constituted of similar assets but of a somewhat larger value. Upon the lawyer's death his separate taxable estate was valued at $100,000, on which a tax of $4800 was paid. Upon his wife's subsequent death, her $100,000 taxable estate also paid a tax of $4800, a total tax on both estates of $9600, or approximately 40 percent of the tax paid by the engineer and his wife, although the estates of the lawyer and his wife were 25 percent larger!

Faulty Philosophical Premises of the Present Laws

Laws Do Not Treat a Normal Situation Normally

An obvious conclusion which can be drawn from the above narrative is that competent legal advice should have been sought and used by the engineer and his wife. However, their response to this suggestion during their lives would probably have been (i) we're not rich enough to worry about it, and (ii) besides, all our property is jointly owned and this is best because if either of us dies the other gets the property without the delay and expense of probate administration.

A less obvious, but equally valid, conclusion is that laws which cause an undesirable result when applied to a situation which is "normal" should be changed. It is common today to find married couples to whom the following facts apply: 1) Their estate is large enough to be subject to the federal estate tax, and this tax can have a severe impact, perhaps at the death of the first spouse and often at the death of the second.[4] 2) The value of their property has increased gradually and subtly, and their home and life insurance make up a large part of their estate; as a result they do not regard themselves as being wealthy enough to require "estate planning." 3) They own their property jointly, with right of

4. Tax Reform Studies 4.

survivorship, because it is both consistent with their idea of the marriage relationship and an effort to "avoid probate" and its concomitant delay and expense. 4) They regard all assets they have accumulated, no matter how legal title is held, as "their" property, not "His and Hers."[5] The abnormal result of applying the gift and estate tax laws to such a situation has already been illustrated.

Even those who are conscious of the need for help have a difficult time under the present laws. The estate of many married couples is accumulated (i) as a result of the separate earnings of each of them during at least part of the marriage, (ii) from the separate inheritances of each of them, and (iii) from the growth of an income from prior accumulations. All of this makes the task of reconstructing the situation after many years practically impossible, even though such a reconstruction is required to avoid an unnecessary increase in taxes under the present laws.

Laws Adversely Affect Choices on Non-tax Issues

The attorney who is called upon to formulate an estate plan knows that he must first, within the framework of his client's present and expected assets and liabilities and subject to the limitations of the law, meet the practical needs of the client and his beneficiaries. He knows also that tax planning, although important, is an incidental feature. However, the present gift and estate tax laws too often make the formulation, implementation and functioning of an estate plan which is ideally suitable to practical needs so expensive in taxes that it becomes undesirable.[6] For example, a husband may want his wife to have complete financial flexibility and, having unlimited confidence in her "business sense," desire that everything pass to her outright. The lawyer must warn his client that this plan could subject the estate to taxation one and one-half times[7] and, therefore, unduly diminish the estate to the detriment of their children who might need these resources. On the other hand, reducing the tax will require additional expense in preparing the will and administering a trust for the wife and, most importantly, will actually be contrary to the client's desires on the non-tax issues.

Laws Contravene Marriage Relationship

The philosophy of the present gift and estate tax laws, which regard

5. TAX REFORM STUDIES 119; A. Casner, *ALI Federal Estate and Gift Tax Project*, 22 TAX L. REV. 515, 549 (1967) [hereinafter cited as Casner].
6. TAX REFORM STUDIES 112; Casner 548.
7. Although only one-half of the estate would be taxed at his death, the entire estate would be taxed again at her death, assuming no shrinkage and that the second death occurs ten years or more after the first.

husband and wife as strangers who must deal at arm's length with respect to their estate, is unrealistic, and the marital deduction is an inadequate attempt to rectify this basic error. As was noted by A. James Casner, the Reporter for the American Law Institute Estate and Gift Tax Project:

> The present transfer tax laws impose an unrealistic burden on husband and wife in regard to the transfer back and forth of their respective funds. A more realistic tax concept in this area may be that of the average husband and wife who refer to "our" property without regard to the technical aspects of legal ownership.[8]

Married couples should not be compelled by the threat of higher transfer taxes to treat each other as strangers by being forced to regard property which is brought to the marriage or accumulated during the marriage as belonging to the person who brings it or whose efforts produce it. If a couple does want to maintain such a posture, they have the option of so doing and accepting the tax burden. But this burden should not be extended to those who do not choose to so treat the marriage relationship.

Laws Create Inequities at State Boundaries

Furthermore, the impact of federal transfer taxes should not vary depending upon which state law applies.[9] Under the present system, if the state in which a couple is domiciled has the law of community property, the federal estate tax will be substantially smaller if the "poorer" spouse dies first than would be true under identical circumstances in a common law state.[10] In addition, if the spouse whose efforts produce the property regards it as belonging to both himself and his wife and he registers ownership accordingly, he may be making a reportable gift in a common law state; but will not be doing so if he lives in a community property state. A uniform tax result is essential in our increasingly mobile society.

PROPOSED TAX LAW REFORM

At the time this article was being written, the United States Treasury Department had just submitted its comprehensive tax law

8. Casner 549.
9. *Id.*
10. In a community property state, as a general rule, half of such property is regarded as belonging to each spouse and upon the death of the first spouse only that person's community share of the property will be taxable. The second spouse's half will likewise be taxable at that person's death. Consequently, the effective tax rates after the death of both spouses will be lower than in a common law state.

reform proposals to Congress. Included in these proposals were many changes in the gift and estate tax laws. Although the proposals had been released to the public immediately before the deadline for this article, public hearings had not yet begun and informed comment was sparse. A story in the Wall Street Journal stated:

> The Treasury study proposes removing the 50% limitation on the amount of property that can pass tax-free from a husband to his wife at death. It also proposes liberalizing and simplifying the rules on the types of interests in property that may qualify for the marital deduction. The study says the changes will benefit smaller and medium size estates. . . .[11]

It can be assumed that the results of the American Law Institute Estate and Gift Tax Project,[12] approved by the ALI at its annual meeting May 23-24, 1968, played an important part in the Treasury's study.

Past History of Such Reform

Tax reform in the area which is the subject of this article has had a strange past. Until recently, when the ALI project awakened interest in the subject, there had been total silence on the part of authors of law review articles since shortly after the marital deduction was added to the gift and estate tax laws in 1948. At that time, however, we find historical antecedents to the present proposals of the Treasury in an article written by the man chiefly responsible for those proposals, Stanley S. Surrey, Assistant Secretary of the Treasury for Tax Policy during both the Kennedy and the Johnson administrations. In a 1948 Harvard Law Review article,[13] Mr. Surrey advocated change to a system which would permit tax-free interspousal transfers.[14] In 1950 a fellow participant with Mr. Surrey[15] in a tax institute elaborated on this idea, noting that:

> If any real improvement [in the taxes] is to be effected, it seems apparent that it will have to be based upon a treatment of inter-spouse transfers which ignores the technicalities of

11. The Wall Street Journal, Feb. 3, 1969, at 8.

12. 3 ABA REAL PROPERTY SECTION 111, 119 (1968).

13. S. Surrey, *Federal Taxation of the Family—the Revenue Act of 1948*, 61 HARV. L. REV. 1097 (1948).

14. *Id.* at 1161.

15. The slow turn of the wheels of tax reform can be seen by the following observation by Mr. Surrey, made nearly 20 years ago: "It now appears, however, that the transfer taxes are about to enter a new era. Revision of these taxes is in the air today, and their long overdue remodelling would seem ready to begin." S. Surrey, *An Introduction to Revision of the Federal Estate and Gift Taxes*, 38 CALIF. L. REV. 1, 3 (1950).

various forms of property ownership as between husband and wife.[16]

Others have urged this reform in the past,[17] but since the creation of the marital deduction their voices had been still, and authors of law review articles had been content with jousting with the complexities of the marital deduction; seemingly convinced that it was here to stay. In 1962, however, the ALI authorized the Federal Estate and Gift Tax Project. Numerous drafts, dealing with all phases of the two laws, were studied by consultants to the Reporter and by the Tax Advisory Group. These, in turn, were refined into Study Drafts which, after further refinements, were submitted to the ALI 1968 annual meeting. Included in the final ALI draft is the proposal that certain qualified transfers between spouses, during life and at death, be free of federal gift and estate tax.[18] The Treasury Department has now made the same recommendation.[19] The balance of this article will discuss the interspousal transfer feature of the ALI and Treasury proposals, point out two major areas of concern with respect to the operation of their proposals and suggest an alternative proposal which would eliminate these concerns while also permitting tax-free transfers between spouses.

Reform Proposal with Respect to Interspousal Transfers

Transfers Which Qualify

Although the ALI and Treasury have proposed that both lifetime and death-time transfers between spouses be free of federal transfer tax, the 100 percent tax-free interspousal transfer rule would not apply to every transfer. In order to qualify, the proposal requires that the transfer vest in the donee spouse the "current beneficial enjoyment" of the property. This means that the property must pass outright to the spouse, or the donee spouse must be entitled to enjoyment or use of the property or the income from it, or that the donee spouse must be entitled to obtain, by reason of a power presently exercisable by her alone, outright ownership, enjoyment or use of the property or the income the property produces. No one else may be given the current physical beneficial enjoyment of the property.[20] Such a transfer will be qualified whether it is of the current beneficial enjoyment of all ownership aspects of the

16. A. DeWind, *The Approaching Crisis in Federal Estate and Gift Taxation*, 38 Calif. L. Rev. 79, 109 (1950).
17. *See* J. Platt, *Integration and Correlation—The Treasury Proposal*, 3 Tax L. Rev. 59 (1947).
18. 3 ABA Real Property Section 111, 119 (1968).
19. Tax Reform Studies 28-32, 104, 122, 329-87.
20. *Id.* at 377.

property or just part of them, including the cases in which a stated annual sum is to be paid out of the property.[21] The transfer will also be qualified whether it is for the life of the donee spouse or for a shorter period, such as for a stated term or until remarriage.[22]

By way of illustration, the proposals would permit a husband to make an outright inter vivos gift to his wife of property of whatever value, to cause such property to be registered in their names as tenants by the entireties, and to bequeath such property to her outright; all without tax. Furthermore, he could, with the same consequences, put the property in trust for her, even though the terms of the trust would provide that his wife would be entitled to only the income until her death or remarriage; and that thereupon the corpus of the trust would be distributed to their descendants. Similarly, insurance proceeds of a policy on the husband's life could be paid to the wife upon the husband's death. Likewise, the proceeds could be retained by the company under an option by which it agrees to pay her the income for the designated period and then make distribution to the descendants, or could be paid to a trust with similar provisions, again without tax. Such a rule is much more liberal than the present "terminable interest" rule and, therefore, provides great flexibility in choosing an estate plan which genuinely meets the individual's needs.

Imposition of a Later Tax

While there would be no federal estate tax at the husband's death with respect to property in which he transferred a qualified interest to his wife, a taxable transfer would be made upon the termination of the wife's current beneficial enjoyment in the property.[23] Thus, if the termination occurred at the end of a stated period of time or upon her remarriage, the tax would be measured by the value of the property at that time and a gift would be regarded as having been made by the wife to whomever received the property. If that termination occurred at her death, the property would be includable in her gross estate for estate tax purposes.

In order to eliminate a drain on the donee spouse's other property at the end of her current beneficial enjoyment of property which passes to another by the terms of the transfer and outside her own control, the law would provide that the transfer tax is to be collected only out of the property passing, not out of her other property, unless she otherwise

21. Casner 550.
22. *Id.*
23. *Id.* at 552.

directs.[24] The tax rate, however, will be the top rates which apply to her transfers for the period in which her current beneficial enjoyment ends;[25] a rule of no consequence if such event occurs at her death but one which could artificially increase the rates on her later transfers if termination occurs during her life.[26]

Spreading the Tax Between Two Taxpayers

The practical effect of the reform proposals, as they have been described to this point, would be that a transfer of property from one spouse to another would be tax-free in the usual case because the transfer would be a qualified one. However, upon termination of the donee spouse's current beneficial enjoyment, the entire value of the property would be taxable. This would result in a higher estate tax under a progressive rate system than if part of the property were taxed upon the husband's death and the balance (assuming no fluctuations in value, substantial consumption or lifetime gifts by the wife) at the wife's later death. In order to ameliorate this burden, both the ALI and the Treasury proposals provide for rights of election[27] and disclaimer[28] which can be used to create some initial tax and avoid the later tax on part of the property.

Electing to be Immediately Taxed

The ability to make an election would exist in both the donor spouse and the donee spouse, and could be exercised as a feature of post-mortem planning; a time when tax counsel is usually sought in connection with preparation of the federal estate tax return. Thus, the husband can provide in the transfer instrument that part of the property shall be regarded as subject to an immediate transfer tax and, if a method is established for tracing the property which produces that tax, there will be no subsequent tax on that property. He could also specify a certain time of election unless his wife otherwise elects. If he fails to specify either provision in the transfer instrument, the wife is entitled to an election which will produce the lower aggregate tax. Her failure to exercise this right will automatically eliminate a tax upon the transfer to her of the qualified interest. As noted by the ALI Reporter:

> The wide ranging proposed election system is designed to make more easily attainable the most advantageous tax result, and

24. TAX REFORM STUDIES 378.
25. Casner 553.
26. J. Alexander, *Federal Estate and Gift Taxation: The Major Issues Presented in the ALI Project*, 22 TAX L. REV. 635, 662 (1967).
27. Casner 553; TAX REFORM STUDIES 379.
28. Casner 554; TAX REFORM STUDIES 387.

thereby reduce the necessity of highly skilled advance tax planning.[29]

The proper use of the right of election can best be seen in situations involving the estate tax. As noted above, the husband who does have the benefit of lifetime estate planning can *suggest* an election which appears to be wise at the time he executes the instrument but not make the provision binding. His widow and the widows of those men who never considered estate planning during their lives can, with the help of counsel, survey the situation as it exists at their husbands' deaths and can then decide whether and to what extent they wish to pay an immediate tax and diminish their assets rather than defer the tax at the risk of increasing it under the progressive rates.

Disclaiming Interests to Change Tax Results

Disclaimers could be used under the proposals to both create and disqualify tax-free interspousal transfers. Exercising a right of disclaimer would not, in itself, be a taxable transfer.

A disclaimer which would create a tax-free transfer to a spouse would be one made by an individual who is given an interest in the property which prevents it from being a qualified transfer to a spouse because it precedes the spouse's current beneficial enjoyment. For example, if a husband created a testamentary trust from which his son was to receive the income for a period of time and decedent's wife was then to receive the income during her life, after which the property was to pass outright to their descendants, the transfer would not be qualified and the property would be part of the husband's taxable estate. The son could, however, disclaim his interest and the transfer would become qualified. In this case there would be no taxable gift by the son to his mother since the transfer would be regarded as if the son's interest had never existed.

The donee spouse could also disclaim the current beneficial enjoyment of property so that a successive interest would be accelerated and the transfer would be subject to a tax. Again, this act would not be regarded as a gift by the disclaiming spouse and taxable at her gift tax rates, but as the act of the donor spouse and taxable at the rates which apply to his transfers.

The act of disclaiming would be required to be performed within certain established limitations,[30] including those of time (within fifteen months of the transfer creating the interest to be disclaimed or within six months of learning of the interest, whichever is later) and those of

29. Casner 554.
30. *Id.* at 556.

practical effect (without having exercised control over or knowingly accepted any benefit from the property transferred). Also, the disclaimer could be made by a legal representative on behalf of a deceased individual who would have been entitled to disclaim an interest immediately prior to his death, and such disclaimer would be regarded as having been made by the deceased unless the result would be a net increase in the total taxes which result from the individual's death. Thus further flexibility has been written into the proposal.

A Unified Tax and Interspousal Transfers

Included in the Treasury Department's reform proposal is the recommendation that the gift and estate taxes be unified;[31] that is, that a decedent's transfers at death be added to his transfers during life for the purpose of determining and applying the federal estate tax rates. The right to "split" gifts to persons outside the marriage between the husband and the wife, now permitted only as to lifetime transfers, would be expanded to permit splitting of death-time transfers as well. In addition, the tax code would be changed to permit such splitting in any proportion, including attributing no part of the gift to the donor and all to his spouse.[32] Thus, the donor spouse's lifetime gifts could be treated as made in whole or part by each spouse and his death-time transfers to others could be taxed in whole, in part or not at all to the deceased spouse under the "estate" tax, with the balance, if any, being taxed to the surviving spouse under the "gift" tax. If the deceased spouse's transfers to others are split, the part attributed to him will be accumulated with *his* lifetime transfers, while the part attributed to his wife and his tax-free transfers to her will be accumulated with *her* lifetime transfers when her taxable estate is determined. In short, a decedent spouse's taxable estate can be divided between two rate structures, and the tax lowered, if the couple can afford to make transfers outside the marital unit. But that part of the taxable estate of the first spouse to die which is "taken over" by the surviving spouse will push the qualified transfers to her even higher in the progressive rate structure upon her subsequent death. Such a result is not objectionable because it is a matter of choice.

FLAWS IN THE REFORM PROPOSAL

Although passage of the Treasury proposal as it relates to tax-free interspousal transfers would result in a substantial loss of revenue,[33] few objections can be made to it by taxpayers and their representatives.

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31. TAX REFORM STUDIES 355 *et seq.*
32. *Id.* at 380.
33. *Id.* at 360.

One objection which has been advanced,[34] however, relates to the principle of regarding a donee spouse as having made a taxable transfer upon the termination of a current beneficial enjoyment which by the terms of its creation was so short-lived as to be of no real benefit to the donee spouse. Even though the tax, under the proposal, could only be recovered from the property itself, as noted above,[35] the transfer would increase the rates to be applied to the donee spouse's subsequent transfers of controlled property. The disclaimer privilege would exist in the donee spouse, but it has been argued that the spouse probably would not exercise it and perhaps not even be aware that it was available.[36] The remedy which has been suggested is to require that the donee spouse receive a general power of appointment with her limited interest, a seeming conflict in terms. The rationale of the suggestion is that the controlled property of the donee spouse should not bear the burden of an illusory beneficial interest, and tax-free treatment should only be afforded the initial transfer if the spouse can get to the property to "break even" on the later, higher tax.[37] However, this appears to be an answer which is designed to meet only the needs of the few who desire to minimize the current beneficial enjoyment given to their spouse; even though such a restriction would be detrimental to that spouse if she desired to make future transfers. Such a procedure would create an unwarranted restriction on the flexibility needed by the vast majority of individuals who wish, for good cause, to create only a present limited interest for their spouses.

A more basic flaw in the proposal, it is submitted, is the forced choice of either deferring the tax and risking a higher tax under the progressive rates or lowering the aggregate tax by electing to incur an immediate tax and thus diminishing the surviving spouse's income and security in the process.[38] Certainly the system proposed by the ALI and the Treasury is superior to the present law, but it does not approach the desired result which lawyers presently endeavor to reach with respect to the estate tax: namely, to produce a tax equal to twice the tax on one-half the estate. It may be argued that if married couples are to be taxed as a single financial unit, and be entitled to transfer property to and between themselves without a tax, they must expect to pay a tax equal to that which would be paid by a single individual who has accumulated

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34. J. Alexander, *Federal Estate and Gift Taxation: The Major Issues Presented in the ALI Project*, 22 TAX L. REV. 635, 662 (1967).
35. *See* note 24 *supra* and accompanying text.
36. J. Alexander, *supra* note 34, at 663.
37. *Id.*
38. 3 ABA REAL PROPERTY SECTION 111, 119, 120 (1968).

an estate of the same value; and that under the proposal they already have an option not available to an unmarried person to reduce the overall tax cost by incurring an immediate tax at the death of the first spouse. It may also be urged that the proposed new rate structure[39] takes this problem into consideration with a much slower progression of rates through the lower levels of estates so that taxable estates of low and moderate size will not suffer unduly. It is submitted, however, that married persons should be recognized as a marital unit with respect to transfers between themselves, but with respect to transfers outside the unit they should still be regarded as two people, whose joint efforts and sacrifices have produced the estate subject to the tax. When it is also considered that in order to reduce the aggregate tax by paying an immediate tax the surviving spouse must "trace" the assets (a requirement which will eliminate part of the tax savings by reason of expenses such as fees for regular accounting services and perhaps even for the establishment and operation of a trust), the need for an alternative to this forced decision becomes even more apparent.

Another major flaw in the proposal is that if all or a substantial part of the property is owned only in the name of one spouse and the other spouse dies first, there is no opportunity to diminish the aggregate taxes, and the estate of the second spouse will have to pay a tax as if he had never been married.

The next section of this article will propose a method which would attempt to solve these problems and produce an appropriate tax, while not substantially changing the other features of the ALI and Treasury proposals.

TRANSFER TAXES AND TRUE RECOGNITION OF THE MARITAL UNIT: A PROPOSAL

One desirable objective of tax reform would be to have the estate of married persons taxed as though each owned half, regardless of which dies first; and yet not compel the payment of a tax upon the death of the first spouse to die or require "tracing." To accomplish this result, I believe that it would be necessary to view the estate as two distinct units, both when the first spouse dies and when the death of the second occurs. Once this is accomplished, however, the reform proposals described above could be used in substantially the form submitted.

For the purpose of the following discussion, we will assume that the husband predeceased the wife.

39. TAX REFORM STUDIES 355.

The gross estate of the husband would be all property owned by either of the marital partners as well as property owned by both of them concurrently, with or without right of survivorship. This property would be valued at the date of death. Debts and expenses now allowed as deductions would continue to be deductible in determining the adjusted gross estate.

For the purpose of computing the tax due at the death of the husband, a sum equal to the adjusted gross estate minus the greater of (i) one-half thereof or (ii) the aggregate of property owned by the wife and property in which the husband transferred to the wife a current beneficial enjoyment; this would constitute the first unit. The second unit would consist of the amount by which one-half the adjusted gross estate exceeds the value of the aggregate of property owned by the wife and the property in which the husband transferred to the wife a current beneficial enjoyment.

For the purpose of computing the tax due at the subsequent death of the wife, allowable deductions would again be subtracted from the value of assets which the wife owned and in which she had a current beneficial enjoyment at death. This adjusted gross estate of the wife would again be regarded as two units. The first such unit would consist of the amount by which the property owned by the wife at the husband's death and the property in which the husband had transferred to the wife a current beneficial enjoyment exceeds one-half the adjusted gross estate as reported on the federal tax return filed for the husband.

The wife's second unit would equal the balance of her adjusted gross estate over her first unit. In determining the tax for the wife, the value assigned to her first unit would be "tacked" to the value which had been assigned to the first unit of her husband's estate and the value assigned to her second unit "tacked" to the second unit of the husband's estate. Rates and exemptions would be applied to the units accordingly.

Under the ALI and Treasury proposals, if the current beneficial enjoyment in property created by the husband would terminate during the life of the wife, she would pay a gift tax thereon, recoverable only from the property itself if she had no control over the property, but in any event at the highest rates applicable to her transfers for that period. The same procedure could be followed under the above proposal except that if transfer of that property was not within the wife's control, it would be treated as part of the husband's transfers, not as a gift by the wife. As such, it would be included in his first taxable unit; that is, it would be "tacked" to his first unit and the tax computed accordingly at the appropriate rates. This tax would be paid out of the property unless the wife directs otherwise. If this is done, of course, it would reduce the amount which could be "tacked" to his first unit for later purposes of "tacking" the wife's first taxable unit to his first unit. If the value of the property in which the wife's current beneficial enjoyment ended was of such size that it exceeded the ceiling on the husband's first unit, the balance would be taxed as a gift of the wife. Thus, that property which had been excludable from the taxable estate of the husband would be taxed as though it *had* been a part of his taxable estate. Since it would not then be in the wife's gross estate, it would not be subject to the estate tax due upon the wife's death.

Under this new proposal, if the unified transfer tax discussed above[40] is accepted, the right to split lifetime and death-time transfers to one other than the surviving spouse would be retained. To the extent that the non-donor spouse "takes over" such transfers during life, the donor spouse's accumulated gifts will be decreased and the non-donor spouse's accumulated gifts will be increased. To the extent that the surviving spouse "takes over" such transfers which were not qualified transfers to her, the deceased spouse's first taxable unit will be decreased so that less estate tax will be due, but an immediate gift tax will be incurred by the surviving spouse. In addition, the surviving spouse's accumulated gifts will be increased so that upon her subsequent death, more of her property will have to be "tacked" to the first taxable unit of the first deceased spouse's estate and any excess will "tack" to both the first spouse's second taxable unit and her own prior accumulated gifts. As under the Treasury proposal, if this results in a higher aggregate tax, it is a matter of choice, not chance.

Elections and Disclaimers

The same system of elections and disclaimers available under the ALI and Treasury proposals[41] could be available under this new proposal. For example, the husband could specify an election or the surviving spouse could elect to regard as immediately taxable a transfer to her of all or part of the property which would otherwise constitute a qualified tax-free transfer. Since there would be no benefit in rates in doing so, there would be little incentive in the usual cases to immediately pay a tax which could be deferred without penalty. However, the option could be useful for those who wished to pay the immediate tax and thus permit a later tax-free transfer; and in such instances tracing would be required.

Similarly, disclaimers should be available to preserve flexibility for non-tax reasons. Their use, however, would not diminish the overall tax.

The system suggested above will create two equal taxes only to the

40. *See* notes 31-32 *supra* and accompanying text.
41. *See* notes 27-28 *supra* and accompanying text.

extent that there are two equal estates, and if values of assets given to the surviving spouse increase or decrease, or if she adds to the estate or consumes the property, the tax due upon her death will be similarly increased or decreased. It should be noted, however, that ordinarily this will be entirely reflected in the tax on the second unit of the second spouse to die, without attribution to the first unit. Consequently, there is less incentive to the surviving spouse to reduce his property than there is under the ALI proposal under which the progressive rates apply to the entire estate.

CONCLUSION

> Properly constructed transfer taxes . . . would offer tax neutrality instead of tax preferences, and thereby permit an individual to shape the transmission of his wealth uninfluenced by the tax magnetism of certain courses of action. The government's share of the wealth would as far as possible be determined by the amount of the wealth and not by the manner of its transfer to others.[42]
>
> If taxpayers are treated differently where there is no fundamental difference in their situations other than geographical location, for example, or if the normal and routine transfers which people are inclined to make among family members are subject to unnecessary complex rules in regard to tax consequences, or if the tax result is largely controlled by form and not by substance, the judgment of an unfair tax system is likely to be pronounced with respect to it.[43]

These two quotations, the second made almost twenty years after the first, are excellent observations on the need for tax law reform of the kind which is the subject of this article. Perhaps in the next two years such reforms will be enacted by a Congress which has shown an increased awareness that the tax laws must reflect reality.

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42. S. Surrey, *supra*, note 15 at 9.
43. Casner 518.