TRANSFER TAX REFORM AFTER EGTRRA-2001: RECONSTRUCTION OR FURTHER DECONSTRUCTION?

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I. INTRODUCTION

To say that the transfer tax system from its inception has been controversial adds nothing to the debate. This characterization is noted as a matter of course in a number of legal texts currently in use, but recent events add additional chapters to this history and provide grounds for further discussion.

Grayson McCouch has described the initial political environment surrounding the changes to and temporary “sunset” in 2010 of the Estate and Generation Skipping Transfer Tax under Economic Growth and Tax Relief Reconciliation Act of 2001 (2001 Act). He has related a story of political maneuvering that had, at its core, the single-minded commitment to create a Congressional critical mass to permanently repeal the “death tax.” This commitment remained

1 See e.g., PAUL R. MCDANIEL, JAMES R. REPETTI & PAUL L. CARON, FEDERAL WEALTH TRANSFER TAXATION 4 (5th ed. 2002) (noting that early twentieth century politics was epitomized in part by struggle between groups opposed to any kind of wealth tax and proponents of such taxes). The debate had a social as well as a revenue component. The authors note that “President Theodore Roosevelt strongly supported a heavily progressive inheritance tax as a means of decreasing the concentration of wealth.” Id. In the same vein, the authors further note that Andrew Carnegie, “in his essay ‘The Gospel of Wealth’[,] argued that parents left great fortunes to their children only because of misguided affection, and that the evils inherent in an institution of inheritance far outweighed its few benefits.” Id.

At present, the estate and gift taxes account for only 1% of federal revenues. See JANE G. GRAVELL, ECONOMIC ISSUES SURROUNDING THE ESTATE AND GIFT TAX: A BRIEF SUMMARY, CONGRESSIONAL REPORT SERVICE REPORT RS20609 at 2 (updated Mar. 18, 2008) (“The estate and gift tax is a comparatively small source of federal tax revenue, accounting for about 1% of federal receipts, an amount which has declined following the reduction in rates and the increase in exemptions enacted in 2001.”) [hereinafter Gravell Report]. This anemic fiscal performance has led one writer to observe that “the case for today’s gift and estate taxes rests squarely on equalitarian foundations, to which those other theories are little more than decorative buttresses.” See BORIS BITTKER, ELIAS CLARK & GRAYSON M. P. MCCOUCH, FEDERAL AND GIFT TAXATION 6 (8th ed. 2005).

The debate over these taxes continues presently with proponents citing the taxes’ contribution to overall progressivity in the income tax system, concern for the perceived deleterious societal effect of inherited wealth, and the importance of reaching and taxing unrealized capital appreciation. See Gravell Report, supra note 1, at 1-2. Opponents of the taxes counter with criticism of the taxes’ asserted negative effect on savings and economic growth, and the perceived burden placed thereby on family businesses and farms. Id. at 3.

steadfast during the early years following EGTRRA’s passage.\textsuperscript{3} Ronald Aucutt described the attempts during 2005, 2006, and 2007 to finally achieve repeal, even as possible compromises to the structure pre-existing 2001 were sought.\textsuperscript{4} He joins McCouch in suggesting that the single-mindedness of those advocating permanent repeal may have been an important factor in thwarting amendment as repeal efforts faltered.\textsuperscript{5} Aucutt has concluded that there now appears to be little likelihood for repeal of these taxes.\textsuperscript{6} Instead, he suggests that both taxes will likely be continued and reintegrated with the gift tax. The revised structure would comprehensively tax gratuitous transfers whether inter vivos or testamentary and irrespective of temporal considerations in a comprehensive ongoing federal transfer tax system.\textsuperscript{7}

\textsuperscript{3} Id.
\textsuperscript{4} Ronald D. Aucutt, Recent, Current, and Future Congressional Attention to the Estate Tax (Mar. 14, 2008) (on file with author).
\textsuperscript{5} Aucutt reports that in September of 2005 the Senate was scheduled to vote on repeal of the estate tax after the earlier passage by the House of the Death Tax Repeal Permanency Act of 2005 (DTRPA). Repeal required sixty votes, a level of senate support that was not yet assured. Compromise talks continued as did efforts to garner the votes necessary for repeal. Hurricane Katrina intervened and the Senate vote was postponed. A June 2006 Senate vote on a cloture motion to either approve or amend the bill failed fifty-seven to forty-one. Id. at 1–2.

Two subsequent bills that would have amended the estate and gift tax as it presently exists were subsequently passed by the House. Neither won Senate approval. H.R. 5638, the Permanent Estate Tax Relief Act of 2006 (PETRA) was not brought to the Senate floor. Id. at 3–4. A cloture motion in the Senate to consider a second bill, H.R. 5970, the Estate Tax and Extension of Tax Relief Act of 2006 (ETETRA) failed by a vote of fifty-six to forty-two. Id. at 4.

\textsuperscript{6} He points to three factors in support of his opinion: (1) deep and resolute opposition to repeal of the tax, (2) dilution of support for total repeal in any case, and (3) the current fiscal climate as well as concern for the negative signal likely to result from “tax cuts for the rich.” Id. at 7.

\textsuperscript{7} Aucutt observes “[a]lthough the models of 2006 — H.R. 5638 and H.R. 5970, PETRA and ETETRA — could be abandoned in favor of a totally new start, that rarely happens.” Id. at 11. He then goes on to suggest ways in which reform might be moved forward. Id. at 11–13.

With the focus on reform he joins a number of commentators including Joel Friedman, Estate Tax Repeal Would be Costly, Yet Benefit Only a Few, 95 Tax Notes 1984 (June 24, 2002); Jonathan G. Blattmachr, Mitchell M. Gans, Wealth Transfer Tax Repeal: Some Thoughts on Policy and Planning, 90 Tax Notes 393 (Jan. 15, 2001); and Denis J. Ventry, Jr., Straight Talk About the ‘Death’ Tax: Politics, Economics, and Morality, 89 Tax Notes 1159 (Nov. 27, 2000). The case for reform is well summarized by Gravelle, who makes the following points: (1) “an estate and gift tax... contribute[es] to progressivity in the income tax system”; (2) a tax on inherited wealth
Should this prove to be the case, Congress for the first time in almost a decade will have an important opportunity to comprehensively reconsider and reconstruct Subtitle B. The manner in which Congress meets this challenge could well determine whether the system, with regard to the affected taxpayers, will function reliably and predictably from the point of reconsideration forward or whether Subtitle B will become primarily a trap for the unwary.

Aucutt has noted that reform should be attentive to both tax relief and base-broadening. I agree with this observation. In approaching the task of reform, I think it important to keep in mind that — even as a committed core of “death tax” opponents sought with a single-minded zeal to achieve repeal — estate planning practice, agency Subtitle B administration and oversight, and taxpayer expectations continued to change in significant ways. I argue that these offsetting and dynamic forces will invariably affect both the course of Congressional action and taxpayer expectations going forward. In support of this point, I offer three examples drawn from the last several years: (1) the estate planners, (2) the agency, and (3) the taxpayers.

A. The Estate Planners

The first example is drawn from estate planning practice itself. Estate planners continue to exhibit skill and imagination in devising ways to reduce or avoid both gift and estate tax liability. The most recent, significant addition to the panoply of sophisticated techniques so deployed is, arguably, the Family Limited Partnership (FLP). This may be seen as a windfall to the recipient and thus fairer than a tax on earnings; and (3) the tax remains the only way to reach the income tax's unrealized appreciation. See Gravelle Report, supra note 1, at 2.

To be sure, other commentators have advocated repeal of the present system but with enactment of an alternative system. See, e.g., Joseph M. Dodge, Estate and Gift Tax: Comparing a Reformed Estate Tax with an Accessions Tax and an Income-Inclusion System, and Abandoning the Generation-Skipping Tax, 56 SMU L. REV. 551 (2003); Charles O. Galvin, To Bury the Estate Tax, Not to Praise It, 52 TAX NOTES 1413 (Sept. 16, 1991). Importantly, the writers in both cases would provide some mechanism for reaching unrealized capital appreciation.

Note, however, that even if Congress pursues reconstruction of Subtitle B, EGTRRA-2001 has contributed to changes in estate tax planning that are, likely, irreversible. Specifically, restoring the state death tax credit and recoupling the gift and estate tax exemption equivalent amounts, even if desirable as a matter of policy, will be very difficult to accomplish because they will be viewed as revenue losers. As such, advocates of either or both will face difficulty in gaining the necessary political traction.
tactic, from all accounts, appears now to be widely utilized in planning estates. Typically, property belonging to the transferor is transferred to a limited partnership. Minority interests in the partnership are then given to transferees. If the arrangement is appropriately structured, and proponents can establish legitimate and credible nontax reasons for the FLP, the value of the minority interests can be discounted for gift and estate tax purposes because of lack of marketability and lack of control. The kinds of assets that have been used to fund FLPs, range from relatively illiquid, such as shares in family closely-held businesses, to easily marketable assets, including interests in publicly traded entities, to clearly liquid cash positions. Further, the value of the interest that remains the property of the transferor may be, similarly, discounted if it is held until death. Discounts can be substantial. Those who fail to follow the formalities may be treated as having gratuitously transferred property at FMV. Alternatively,

10 See e.g., Estate of Bongard v. Commissioner, 124 T.C. 95 (2005) (describing how creation of a holding company facilitated corporate liquidity when pooling of assets was allowed); Estate of Bigelow v. Commissioner, 503 F.3d 955 (9th Cir. 2007) (noting that there was no significant nontax reason for FLP when pooling was not allowed).
11 Under section 2703(a), property is to be valued for transfer tax purposes at fair market value without regard to "any option, agreement or right to acquire or use the property at less than fair market value ... or ... any restriction on the right to sell or use such property." Under section 2703(b), however, this rule is inapplicable (1) "if the agreement is a bona fide business arrangement," (2) "is not a device to transfer property to decedent's family for less than adequate and full consideration," and (3) is "comparable to similar arrangements entered into in an arms' length transaction."
12 See, e.g., Strangi v. Commissioner., 417 F.3d. 468 (5th Cir. 2005). (describing an FLP funded with cash, marketable securities, real estate, insurance policies, annuities, and other partnership interests).
14 See, e.g., Strangi v. Commissioner, 417 F.3d. 468 (5th Cir. 2005).
15 See, e.g., Kimbell v. United States, 371 F.3d. 257 (5th Cir. 2004); Estate of Schutt v. Commissioner, 89 T.C.M. (CCH) 1353 (2005).
16 See, e.g., Estate of Kelley v. Commissioner, 90 T.C.M. (CCH) 369 (2005) (noting that the Tax Court allowed a total valuation discount of approximately 30%); Temple v. United States, 423 F.Supp.2d 605 (E.D. Tex. 2006) (showing that the district court applied a 38% lack of marketability and a 60% minority discount).
17 In each of the following cases, the Service successfully invoked section 2036(a)(1) in bringing property that had been conveyed to an FLP into the transferor's estate: Strangi v. Commissioner, 417 F. 3d. 468 (5th Cir. 2005); Estate of
the transfer may be deemed an indirect gift of assets rather than a direct gift of a partnership interest.\textsuperscript{18}

Importantly, in the absence of statutory language, these cases are factually driven. Taxpayer success in litigated cases has been considerable. The Internal Revenue Service (Service) has all too often lost in ongoing attempts to establish limitations on the use of the FLP technique in a number of ways. For example, the “gift on formation” argument has been forcefully rejected by the courts.\textsuperscript{19}

The argument “that a partnership formed without a sufficient business purpose must automatically be disregarded for transfer-tax purposes” has suffered a similar fate.\textsuperscript{20} Thus, it is presently the case that, when effectively deployed, FLPs can effectively make significant amount of wealth “disappear.”\textsuperscript{21}

Two points merit re-emphasizing here: (1) these cases are factually driven and (2) unlike prior instances in which taxpayer utilization of a particular technique verged on the abusive, such as transfer of wealth evidenced by interests in family closely held businesses,\textsuperscript{22} Congress has failed to intervene.\textsuperscript{23} Instead, during this

\begin{thebibliography}{9}
\item See, e.g., Shepherd v. Commissioner, 115 T.C. 376 (2000) aff’d 283 F.3d. 1258 (11th Cir. 2002) (describing how the father and sons received partnership interests that were disproportionate to property contributed to the partnership); Senda v. Commissioner, 433 F.3d. 1044 (8th Cir. 2006).
\item There will not be a deemed gift on formation based upon the difference between the value of the property transferred to the partnership and the value of the partnership interest. The difference is, instead, attributable to the minority and marketability discounts. See, e.g., Estate of Jones II v. Commissioner, 116 T.C. 121 (2001); Strangi v. Commissioner, 417 F.3d. 468 (5th Cir. 2005) (describing how an FLP was disregarded ultimately under section 2036(a)(1)).
\item Former Service Commissioner Donald C. Alexander in 2005 said the following about FLP’s when asked how much he had to do with the Estate and Gift Tax: “I used to practice across the [tax] field in Cincinnati, and at the time I had a lot of experience. Lately, I have gotten out of that area for various reasons, one of them being that you could do only so much in this world and another being that I did not like the idea of these family partnerships. I thought it was crooked, and I wasn’t going to participate in it.” He noted that ending use of FLP was “about the only good reason for repeal [of the estate tax],” but that he thought “that the repeal of the estate tax is a very bad idea.” MAX B. SAWICKY, BRIDGING THE TAX GAP: ADDRESSING THE CRISIS IN FEDERAL TAX ADMINISTRATION 73–75 (2005).
\item In 1990, Congress responded to a cluster of “estate freezing” techniques
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period, Congressional attention remained focused on "death tax" repeal. Thus, efforts to impose constraints in order to prevent abuse have fallen solely to the agency.

B. The Agency

My second example is drawn from changes in the agency. In this context, the 2006 elimination of almost half of the Service attorneys charged with auditing estate tax returns is particularly noteworthy. News of the anticipated cuts was reported in the *New York Times* (*Times*). In response to a *Times* reporter's inquiry, Kevin Brown, a Service deputy commissioner, said that he had ordered the cuts because "far fewer people were obliged to pay estate taxes under President Bush's legislation." Those who criticized the cuts most vigorously asserted that a link existed between the personnel layoffs and the Bush administration's view of the estate tax. In the *Times* article, Sharyn Phillips, a Service estate tax lawyer in Manhattan, noted that "the cuts [are] a 'back-door way for the Bush administration to achieve what it cannot get from Congress, which is

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intended to permit the intergenerational gratuitous transfer of property at artificially low values. It did so by enacting a set of valuation rules to be applied to the offending transfers at the time of the gift rather than at the time of the death of the transferor as had been the case under former section 2036(c). These new rules were codified as Chapter 14 of the Code. Chapter 14 puts in place valuation rules for four categories of transfers: (1) section 2701 — transfers of interests in family controlled corporations or partnerships; (2) section 2702 — transfers of interests in trusts in where the grantor has retained an interest; (3) section 2703 — transfers of interests subject to restrictions affecting fair market value of those interests; and (4) Section 2704 — lapsing rights and restrictions in family controlled corporation or partnerships.

23 See STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, at 396–404 (Joint Comm. Print 2002). The Joint Committee on Taxation has suggested to Congress the form that such rules might take. As part of the analysis for the Estate and Gift Tax, five proposals were made including a proposal to "Determine Certain Valuation Discounts More Accurately for Federal Estate and Gift Tax Purposes." Id. at 396.


25 Id. This proffered defense seems somewhat disingenuous in light of EGTRRA’s revitalization of the estate tax in 2011 after the 2010 moratorium. From Aucutt’s history of legislative efforts to repeal the estate tax, one can reasonably infer that even the most ardent proponents of repeal recognized by 2006 — the year in which these layoffs took place — that the prospects for repeal of the estate tax were dim. See Aucutt, supra note 4, at 1–7.
repeal of the estate tax."26 Brown observed during the aforementioned interview that estate-tax lawyers were the most productive tax law enforcement staff at the Service, finding an average of $2200 of taxes owed, but not paid, to the government each hour that they work.27 Even if one is not persuaded that Phillips’ observation is credible, it seems beyond debate that the loss of a significant portion of a sophisticated workgroup would, at a minimum, undermine this facet of agency activity. If the transfer tax system is to be meaningfully revitalized, Congress must provide the resources needed to reconstruct agency expertise.

C. The Taxpayers

The third point concerns taxpayer attitudes and expectations. Conrad Teitell, an expert in estate planning, made the following observation before the Senate Finance Committee during his November 16, 2007 testimony:

DEATH AND TAXES ARE CERTAIN — THE ESTATE TAX SHOULDN’T BE ARBITRARY.

The arithmetic. An individual who dies on December 31, 2008 leaving a $5 million taxable estate to his or her children will pay an estate tax of $1.35 million. If the same individual survived one more day — until January 1, 2009, when the exemption from the estate tax is scheduled to increase from $2 million to $3.5 million — the tax on the same estate will be $675,000. But if the individual had survived for another year — until January 1, 2010, when the estate tax is scheduled to be eliminated — the estate would not pay any tax. Finally, if the estate tax exemption returns to $1 million in 2011 and beyond the estate would pay a tax of approximately $2 million.28

26 Johnson, supra note 24.
27 Id.
He continues:

To paraphrase Rodney Dangerfield. The fact that the same size estate can have four different tax liabilities — depending solely on dates of death that could potentially be separated by only a few minutes — is not lost on taxpayers. This creates a lack of respect for a tax system and strikes taxpayers as arbitrary. And a lack of respect for the estate tax system can also breed disrespect for the gift and income tax laws.29

Certainly, a serious attempt to "reform" should address as effectively as possible these several factors as well as the need for predictability and stability going forward.

II. ISSUES IN RECONSTRUCTION

A. What Lies Ahead?

Aucutt has, in his usual thorough and detailed fashion, mined the Permanent Estate Tax Relief Act of 2006 (PETRA) and the Estate Tax and Extension of Tax Relief Act of 2006 (ETETRA) for further clues as to the form that this revitalized uniform system might take.30 Ignoring for a moment what we might characterize as the components of reinstatement, such as effective date, exemptions, rates and timing issues, he mentions two areas in which Congress might engage in rate relief and base-broadening in the post EGTRRA environment: (1) rules addressing valuation discounts (base-broadening) and (2) portability between spouses of the exemption/unified credit (tax relief).31 I have already talked a bit about valuation discounts. I will, therefore, limit myself to a brief discussion of the possibility of permitting portability between spouses of the exemption/unified credit for estate tax purposes.

29 Teitall, supra note 28, at 4. One can only wonder about the extent to which the lack of taxpayer education contributed to increasing levels of disrespect. For example, a search of period literature failed to find any publication informing taxpayers of the repeal of section 1014 and the applicability of section 1023 during 2010. Would taxpayers have reacted in the same manner had they been made aware of the narrowing of the window for the exemption of unrealized appreciation for income tax purposes?
30 Aucutt, supra note 4, at 11-13.
31 Id. at 12-13.
B. Estate Planning for Married Couples Simplified?

I will not quibble with the assertion that easier planning for married couples (a favored unit generally for estate tax purposes) is desirable.\textsuperscript{32} Indeed, effective estate planning is likely to be of particular importance for married couples. Recent data shows that the rate of wealth accumulation accelerates as a married couple ages.\textsuperscript{33}

Effective tax planning for married couples is predicated upon the combination of two elements. The first element of this strategy, the credit exemption, has been in place in some form since 1986. By providing a credit that offsets tax liability otherwise payable, Congress insures that some measure of wealth passes from the decedent to successors-in-interest estate tax free.\textsuperscript{34} Currently, as long as each spouse has a taxable estate in an amount at least equal to the credit exemption amount, a married couple will be able to transfer to beneficiaries' estate tax free twice the amount of wealth that could be so transferred by unmarried taxpayers.\textsuperscript{35} This occurs because each spouse, as an individual taxpayer, is entitled to a credit exemption.

Indeed, in recent years, this advantage has become increasingly valuable. Most recently, as has been noted earlier, under EGTRRA the credit exclusion amount has ratcheted upwards. The amount of wealth protected by this credit has increased from $1 million for decedents dying in 2001 to $2 million for decedents dying in 2008. The credit exclusion amount will increase to $3.5 million in 2009.\textsuperscript{36}

\begin{footnotesize}
\begin{enumerate}
\item See William J. Turnier, Three Equitable Taxpayer-Friendly Reforms of Estate and Gift Taxation, 87 Tax Notes 269 (Apr. 10, 2000) (calling for three reforms of the estate and gift tax in order to make the taxes more user friendly and noting that simplified estate planning for married couples was one of objectives to be obtained through such reform).
\item See Robert I. Lerman, The Urban Institute, Do Married Couples Prosper with Age? 1 (2007) ("Overall, the evidence documents significant gains in income and wealth as married couples aged from their late 30s to their 50s.").
\item The credit exemption amount can be found in section 2010(c). The credit, at its present level, effectively protects roughly 99\% of all estates in this country from any estate tax liability.
\item Assume that the available credit exemption amount offsets estate tax on a taxable estate of $1,000,000. An unmarried individual's taxable estate of $2,000,000 will be taxed on the excess over $1,000,000. On the other hand, if each spouse in a marriage leaves a taxable estate of $1,000,000, the credit exemption available to each will offset all liability. The $2,000,000 will pass to successors-in-interest estate tax free.
\item I.R.C. \textsection 2010. In the year 2010, the estate tax (along with the Generation Skipping Transfer Tax) is to be repealed in its entirety only to return in 2011 in its 2001 form. For a detailed explanation, see Title IX of the Economic Growth and Tax Relief Reconciliation Act of 2001, supra note 28. Among other things, this means that
\end{enumerate}
\end{footnotesize}
As noted, success for the marital unit in exploiting this advantage is predicated upon each taxpayer spouse having property of sufficient value to totally utilize the available credit exemption amount. To the extent that the first spouse to die fails to leave an estate of sufficient value to use the credit exemption, the credit is wasted. This is where the second element – the marital deduction – comes into play. The marital deduction allows tax-free inter-spousal transfers, whether inter vivos or testamentary. It, thereby, postpones transfer tax liability on any part of the marital estate so transferred until the transferee’s death. By strategically making inter-spousal transfers, each spouse could be assured of having enough property to offset the available credit while concurrently enjoying the economic benefit of all of the accumulated property. Optimum estate planning for the married couple can thus be achieved through strategic inter vivos transfers even where one spouse has not independently acquired property of sufficient value. No mechanism, however, presently permits the surviving spouse to take advantage of any part of the unused credit exclusion amount where the lesser propertied spouse is the first to die and fails to effectively utilize the credit.

Therefore, the idea of portability is straightforward. A surviving spouse would, upon his death, be able to utilize his own credit exempt amount in addition to any exempt amount left unutilized in the estate of his predeceased spouse. Should Congress elect to permit portability between spouses of the exempt amount, “waste” of the unused credit exemption amount would thus be avoided.

On its face, the proposal seems a reasonable and plausible “next
step” toward simplifying determination of transfer tax liability for a surviving spouse.\textsuperscript{39} In my view, however, portability should not be implemented without reconsidering the options presently available for crafting the form that the transfer to the lesser-propertied surviving spouse will take. Specifically, at present, protection from estate tax may be secured in the estate of a transferee spouse through use of a Qualified Terminable Interest in Property (QTIP) (emphasis added).\textsuperscript{40} I submit that permitting portability to married couples predicated upon anything less than property ownership — an indeterminate interest in property — in the transferee spouse concedes too much control to transferors.

C. Crafting Inter-Spousal Transfers — The QTIP in Context

First, a brief description of the transfer tax treatment of a married couple placing the QTIP in perspective is appropriate. Before 1948, under the Internal Revenue Code (Code), married couples received no special accommodation for estate and gift tax purposes. In community property states, however, when death dissolved the marriage, under the law of the domicile, the decedent’s estate accounted for only half of the marital property.\textsuperscript{41} Estate splitting for these couples for federal purposes followed. Practically, this placed married couples domiciled in common law states at a significant transfer tax disadvantage as compared to couples domiciled in community property states. Common law state couples enjoyed nothing akin to the automatic estate splitting available to couples in community property states. As such, in spite of comparable wealth, transfer tax liability for common law couples would exceed that of couples domiciled in community property states.

This disparity disappeared in 1948. In that year, Congress amended the Estate and Gift Tax in order to permit estate splitting by

\textsuperscript{39} For an early proposal for portability, and a detailed explanation of how portability would work as well as suggested resolutions for inevitable administrative challenges that would follow in the wake of such a change, see Turnier, \textit{supra} note 32, at 269–76.

\textsuperscript{40} Code section 2056(b)(7) was added in 1981. With that amendment to the language of section 2056, Congress for the first time permitted the deduction of a qualifying terminable interest in property. \textit{See infra} notes 48–52.

\textsuperscript{41} Couples in community property states are presumptive equal owners of all wealth that flows into the marriage irrespective of the identity of the person who (1) holds title to property or (2) earns income. In Poe \textit{v. Seaborn}, 282 U.S. 101 (1930), the Supreme Court recognized and, for tax purposes, deferred to community property states’ mandated co-ownership in marital property.
couples domiciled in common law states. This was accomplished through the creation of the marital deduction. From 1948 to 1981 (with a slight modification in 1976), the marital deduction allowed these married couples to transfer up to 50% of solely-owned property to the lesser-propertied spouse without transfer tax liability. The transferee spouse would then include that property in her own estate. As such, the available deduction equalized the tax treatment of married taxpayers irrespective of whether they were domiciled in common law or community property states. All married couples, wherever domiciled, could from 1948 forward enjoy the benefits of gift and estate splitting with each spouse ultimately accountable for one-half of the couple's total property.

This boon, however, came with a price. During this period (and consistent with the deduction operating as a conceptual parallel to the community property system), if the marital deduction were to be available, the interest passing to the transferee spouse from the decedent spouse’s estate had to be an “indeterminate” interest in the transferred property—an interest tantamount to ownership.42 This logically followed since liability for estate tax was deferred until the property left the marital unit. Taxing the value of this property in the estate of the transferee spouse carried out this Congressional intent. The required nonterminable property interest in the hands of the transferee spouse was usually created in one of two principal ways: by outright gift or through the marital deduction power of appointment trust.43 Gifting clearly conveyed ownership to the transferee.44 When the power of appointment trust was used, the combination of an inviolate life estate and a general power of appointment over the remainder in the surviving spouse—even if exercisable only by will—was treated as tantamount to ownership.45

42 The interest could not be one that would terminate or fail during the life of or upon the death of the transferee spouse. It had to be an interest that would be included in the estate of the surviving spouse.

43 Code section 2056 also permits the use of an estate trust to qualify a transfer for the marital deduction. In this trust, the only income beneficiary is the surviving spouse. This trust is not required to distribute income currently to the beneficiary and any accumulated income along with the trust corpus is payable to the estate of the surviving spouse. This interest is not a terminable interest. It cannot fail because of the lapse of time or the occurrence of an event.

44 An unconditional gift is, of course, the seminal example of a transfer of an indeterminate interest in property. As such, gifted property passing from the transferor spouse qualifies for the marital deduction under the language of Code section 2056(a).

45 See I.R.C. § 2056(b)(5). An interest passing from the decedent to the surviving
In 1981 Congress, however, altered this scheme in two important ways. First subsequent to passage of the Economic Recovery Tax Act of 1981 (ERTA '81), couples could make inter-spousal transfers without limit. The one-half limitation that had been in place from 1948 to 1981 on the amount transferable was no longer controlling. Second, Congress dramatically altered the nature of the qualifying interest for a transferee spouse. Owner spouses were provided an additional way to take advantage of the marital deduction: the elective Qualified Terminable Interest in Property (QTIP) (emphasis added). The new terminable interest in property qualified for the marital deduction as long as the transferee spouse received an interest for life in an undivided share of the income from the property payable annually. The transferee spouse need not be provided an interest tantamount to ownership (that is, control over the remainder interest) in that property. Notwithstanding the absence of ownership, if the QTIP election is made and if the transferee spouse makes no transfers during life, the value of the property in which the transferee spouse holds a qualifying income interest will be taxed in the estate of that spouse. If the transferee spouse makes any lifetime gifts of the qualifying interest, the donee spouse in like fashion will be liable for


47 Id. Section 403(a)(1)(A) repealed former Code section 2056(c). The latter provision contained the dollar and percentage limitations that had previously limited the marital deduction.

48 Under Code section 2056(b)(7), the value of property passing from a decedent "in which the surviving spouse received a qualifying income interest for life would be," at the election of the decedent's executor, deductible from the gross estate.

49 In order for the interest to qualify under Code section 2056(b)(7), three requirements must be met: (1) "the surviving spouse [must be] entitled to all of the income [(or a specific portion of it)] from the property, payable annually or at more frequent intervals" (I.R.C. § 2056(b)(7)(B)(ii)(I)); (2) no person may have the power to appoint trust property to anyone other than the surviving spouse during that spouse's life (I.R.C. § 2056(b)(7)(B)(ii)(II)); and (3) the executor must elect QTIP treatment (I.R.C. § 2056(b)(7)(B)(ii)(III)).

50 See I.R.C. § 2044. The property subject to the QTIP is included in the surviving spouse's gross estate. As is true with outright gift or power of appointment trust, in this way the married couple enjoys the privilege of deferral of liability after the transferor spouse's death. When the property leaves the marital unit, the transfer tax is levied.
any gift tax.\footnote{See I.R.C. § 2519. Under that provision, the inter vivos transfer of all or part of a qualifying income interest is treated as a taxable transfer of all interests in the underlying property related to that income interest. As such, the transferee spouse is liable for appropriate gift tax.} In short, the spouse who is the beneficiary of a QTIP trust bears the burden of any transfer tax without having received control tantamount to ownership in the underlying property.\footnote{See I.R.C. § 2207A. This apportionment rule insures that any transfer taxes imposed on the QTIP property will be borne by that property. Apportionment, however, does not protect a transferee spouse’s estate from bracket creep and resultant higher overall liability (to the economic detriment of the surviving spouse’s successors-in-interest) should the transferee spouse independently own property that is included in her estate.}

\textbf{D. The Case Against the QTIP}

Legislative history from the period reflects Congressional concern for owner spouses who faced conflicting estate planning considerations: property owners who had to provide for a surviving spouse, but also wished to avoid the risk of having their children disinherited.\footnote{Disinheritance could well follow where the marital deduction was predicated upon outright gift or the power of appointment trust. The transferee spouse, as owner, could obviously do with the property what she wished. Anxiety over possible disinheritance of children may well be heightened when the surviving spouse is not the biological parent of the transferor’s children. The legislative history is quite explicit on this point. The change permitting deduction of the qualifying terminable interest is explained as follows: “[U]nless certain interests which do not grant the [transferee] spouse total control are eligible for the unlimited marital deduction, a decedent would be forced to choose between surrendering control of the entire estate to avoid imposition of estate tax at his death or reducing his tax benefits at his death to insure inheritance by the children.” H.R. REP. NO. 97-201, at 160 (1981) (Conf. Rep.).} The marital deduction language as amended, by providing for a qualified terminable interest in combination with retained control over the remainder interest in the transferor, was broad enough to encompass these and other considerations. The language did not limit, however, the use of the QTIP to a particular scenario. In fact, this technique could be, and from all indications has been, employed in estate planning for any marriage including long-term, stable, single-spouse marriages presenting none of these considerations. Given this undeniably attractive invitation to property owners to exercise dead-hand control, some commentators have indicated that estate planners would, at the behest of owner-spouses, routinely gravitate to use of the QTIP arrangement rather than
The concern of other commentators was that, given existing demographics, nonpropertied women were most likely to be disadvantaged by owner-spouse reliance on such trusts.55

In short, the QTIP clearly accords tremendous tax as well as nontax advantages to propertied spouses in common law states. Since 1981, these property owners have been able to both exploit the advantages of estate splitting and retained control over the property’s final disposition. They are able to do so at the reduced price of an income interest. As such, the QTIP has two perverse effects: (1) unpropertied or lesser-propertied spouses in common law states receiving only a QTIP interest wind up as the biggest losers from the standpoint of spousal equality and (2) comparatively, married couples in community property states whose estate splitting is premised upon actual ownership suffer no transfer tax disadvantage, but clearly do not enjoy the same quantum of control as do their common law counterparts.

First, again briefly compare the Congressional signal with regard to spouses receiving only a QTIP interest with the treatment of transferee spouses between 1948 and 1981. Though possibly heavy-handed, the effect of the 1948 formulation of the qualifying interest for marital deduction purposes was undeniable. It constituted a powerful incentive to property owners (primarily husbands) to convey an ownership interest to nonpropertied spouses (primarily wives). Transferee spouses could credibly be viewed as “partners” in the marriage to that extent. Further, by so doing, Congress achieved a rough equity for transfer tax purposes between married couples, irrespective of the state of marital domicile. Whether domiciled in a community property or common law state, each spouse would account for one-half of the marital property predicated upon property

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54 See e.g., Jerome A. Manning, Anita S. Rosenbloom & Seth D. Slotkin, Manning on Estate Planning 2-45 (6th ed. 2005). “Since the introduction of this approach [the QTIP] to the marital deduction, the technique has been warmly received, and the use of the classic trust which required the grant of a general power of appointment to the spouse has greatly diminished. The newer trust, requiring only that income be paid to the surviving spouse, gladdens the client who has been married more than once, because he or she can assure an inheritance at his or her spouse’s death for offspring of earlier marriages. It also is welcomed by clients who married only once: they are able to deny control of the principal to their surviving spouse should they remarry or find new companions without benefit of clergy, or just because denial of control seemed justified.” Id.

ownership if a spouse's estate were to enjoy the appropriate quantum of protection from the credit exemption.

With the creation of the QTIP as a qualified interest, Congress once again distanced the lesser-propertied spouse domiciled in a common law state from his or her counterpart domiciled in a community property state. After 1981, the estate of the lesser-propertied spouse in the common law state would still account for any interest conveyed pursuant to a QTIP, but without having ownership of the underlying property. In short, the transferee spouse would enable the transferor's clear tax advantage and control without receiving the ultimate economic benefit — property ownership. In the words of Dukeminier and Johanson, “the homemaker (or the spouse with lower earnings) appears further now than before from being treated as well as her counterpart in community property states — as deserving a share of outright ownership in recognition of her contribution to the economic gains of marriage.”

This outcome is, on another level, deeply ironic. I have already established the economic disadvantage for the spouse who is the beneficiary of a QTIP trust. In the same vein, a transferee spouse who receives property by outright gift or through a power of appointment trust becomes the owner of that property. It is worthwhile to note that a nonpropertied spouse may well be economically better off as the recipient of a transfer under other rules. Consider the following scenarios. When the first and propertied spouse dies intestate (without a will), the rules of intestacy in every common law state award the spouse an outright ownership interest in some percentage of the decedent's spouse property. Where the propertied spouse dies testate (with a will), the surviving spouse may opt not to be controlled by the terms of the will, electing instead to take an elective share of the decedent spouse's estate. The share so taken is in either case

56 JESSE DUKEMINIER, STANLEY M. JOHANSON, JAMES LINDGREN & ROBERT H. SITKOFF, WILLS, TRUSTS, AND ESTATES 429 (7th ed. 2005).
57 See Laura A. Rosenbury, Two Ways to End a Marriage: Divorce or Death, 2005 UTAH L. REV. 1227, 1261–73 (2005). Of importance in this context, Rosenbury points out that the laws of intestacy are not explicitly premised upon a partnership theory of marriage. Id. at 1261. Nonetheless, intestacy gives the surviving spouse absolute ownership of some percentage of the decedent’s property.
58 Id. at 1243–61. As Rosenbury notes, the question of whether this right of election is premised upon a theory of marriage as partnership depends largely upon how the base for the exercise of the right is defined. States that use the Uniform Probate Code’s (UPC) concept of the “augmented estate” can arguably be viewed as “marriage as partnership” states though the augmented estate concept is not co-extensive with the concept of community property. Id. at 1247–52. The status of
eligible for marital deduction treatment. Finally, if the marriage is dissolved by divorce, pursuant to an equitable distribution approach, most common law states award the lesser-propertied spouse ownership to some percentage of marital property, notwithstanding title in recognition of the transferee's contributions to the economic gains of the marriage. A further irony is that equitable division of property incident to divorce is most explicitly premised upon the concept of marriage as partnership. The absence of required creation of an ownership interest for QTIP election clearly disadvantages the surviving spouse, who remains loyal to the wishes of the transferor spouse even after death and despite the absence of any semblance of control. It should not be the case that fidelity to marriage and spousal wishes merit inferior tax treatment. Indeed, the QTIP provisions may be viewed as a conceptual throwback to common law dower, a concept that has been largely superseded in state property law.

marriage as partnership, however, becomes less clear where states use a partially augmented estate as base and is inapplicable where the estate is unaugmented. Id. at 1252.

Under Treas. Reg. § 20.2056(c)-2(a) (1994) any property inherited from the decedent is considered as having passed from the decedent to the person who is at the time of decedent's death entitled to receive the property. Likewise, under Treas. Reg. § 20.2056(c)-2(c) (1994), an elective share is considered as having passed from the decedent to the surviving spouse. As nonterminable interests in property, both are therefore deductible under section 2056.

Rosenbury, supra note 57, at 1235–44.

61 Id. at 1236 ("[E]ven unequal but equitable divisions of property [incident to divorce] embrace a concept of marriage as a partnership similar to that employed in the community property states.").

62 Zelenak nicely captured the disconnect between QTIP and marriage as partnership in this comment:

[T]he only reason a husband would use a QTIP trust, rather than an outright spousal bequest or a general power of appointment trust, is because the husband fears his wife will not share his views on the proper ultimate destination of his assets. The fact that the husband has chosen a QTIP trust disproves the assumption of spousal unity upon which the marital deduction is based.


63 Under the common law concept of dower, a widow is entitled to a life estate in one-third of her husband's qualifying land. The right to dower is presently recognized in only four of the following forty-one common law states: Arkansas, Kentucky, Michigan, and Ohio. See Dukeminier et al., supra note 56, at 422–23; Mary Moers Wenig, "Taxing Marriage," 6 S. CAL. REV. L. & WOMEN'S STUD. 561, 572
With regard to the common law and community property disconnect, the “wealth-generating” spouse in a community property state cannot control the community property without, in effect, securing his co-owner partner’s consent. Married couples domiciled in community property states might be said to already enjoy “portability” of the exempt amount in the sense that both partners to the marriage will have property against which to use the available credit. It is, however, portability predicated upon property ownership.

Married couples domiciled in common law states are not co-owners of marital property as a matter of state law. 6 A nonpropertied spouse in a common law state is without a voice in matters of marital property management. No consultation akin to that required in community property states is required in common law states. The marital deduction predicated upon outright gift or a power of appointment trust assured the creation of an ownership interest in the transferee spouse. On the other hand, the QTIP arrangement, as it presently exists, is entirely under the control of the propertied spouse or that spouse’s personal representative and provides for the welfare of the surviving spouse. The required income interest is clearly not the equivalent of absolute property ownership. A nonpropertied surviving spouse, who is the beneficiary of a QTIP arrangement, is the decedent’s ward. As such, the beneficiary spouse may be well provided for, but is clearly not treated as the decedent’s surviving marital partner. I submit that, overall, the QTIP was and is undesirable as a matter of tax and family policy. As Congress decides how to proceed in the transfer tax area, repeal of the QTIP should be one of the first items of business.

E. A Word Or Two About Portability

Portability of the credit exclusion amount is not, in and of itself, an undesirable idea. It would clearly simplify estate tax planning for married couples. Indeed, as has been noted, married couples in community property states already enjoy portability. It is, however, portability premised upon actual ownership of the underlying marital property.

If portability were enacted within a regime that permitted continued use of QTIP transfers, a married couple in a common law state with a single property owner would be able to protect the same

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64 See DUKEMINIER ET AL., supra note 56, at 457–58.
amount for transfer tax purposes as would co-owner married couples domiciled in community property states. Indeed, the addition of portability to the present transfer tax regime could well further undermine the already quite marginal status of nonowner and lesser-propertied spouses. There presently exists an incentive to make inter vivos transfers of income interests to the less-propertied spouse equal to shelter protected amounts. If portability is available simply as a matter of the propertied spouse’s survival of the less-propertied spouse, the incentive to transfer even this interest to the less-propertied spouse disappears.

The enhanced transfer tax advantage for common law state domiciled couples would further distance them from their community property domiciled counterparts. This resultant transfer tax disparity is contrary to a system that purports to seek always to treat similarly situated taxpayers in an equitable fashion. A colleague characterized enactment of the QTIP as awarding the carrot and throwing away the stick.65 The observation becomes more powerful if Congress permits portability with a QTIP. Therefore, if portability is legislated, it should be predicated upon property ownership.

III. CONCLUSION

Estate planners are talented and aggressive specialists — and that is as it should be. That talent should not, however, be exercised without restraint protective of the broader public interest. Assuming that the estate tax is not repealed, (and, as has been noted, it appears that it will not be) Congress must take the necessary legislative steps to restore credibility and vitality to the transfer tax regime. Congressional action must include the infusion of funds sufficient to assure competent and effective administrative oversight. Failure to take action of this breadth will surely accelerate the demise of the transfer tax regime, should it exist after the year 2010, through sheer Congressional inattention.

65 Thanks to Professor Grayson M. P. McCouch at the University of San Diego School of Law for this very apt characterization.