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ESTATE AND GIFT TAX REFORM. INTER VIVOS TRANSFERS WITH A TESTAMENTARY FLAVOR

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THE DOUBLE TAXATION PROBLEM

As soon as the Ways and Means Committee has a chance to get to it, there will be more estate and gift tax reform. The Committee's sense of urgency has been tempered as a result of the Secretary of the Treasury's lack of enthusiasm for reform at this time. However, the Committee has been exposed to extensive studies made by the American Law Institute[1] and the Treasury Department.[2] The scope and timing of reform are still very unsettled, but in spite of rather basic conflicts, even within the Treasury, it can be said that by any standard the reform will be major.[3] This article will discuss the need for reform where a transfer is made in contemplation of death or with the retention of either a beneficial interest in or a power over the transferred property In addition, these subjects will provide an interesting vantage point from which to examine estate and gift tax reform generally

Under present law, there are several situations where transferred property will be included in the transferor's gross estate even though the transfer was complete for gift tax purposes and, therefore, subject to gift tax.[4] This anomaly is caused by the use of different and very esoteric standards under the estate tax from those used in the gift tax for answering the question: Has the transferror sufficiently divested himself of the transferred property so as not to be considered the owner thereof for tax purposes? The confusion is further compounded because almost all of these "string transfers" are made in trust, and the standards set forth in the grantor trust income tax pur-

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1. ALI, FEDERAL ESTATE AND GIFT TAXATION (1969) [hereinafter cited as ALI PROJECT].

2. U.S. TREAS. DEPT., 91ST CONG., 1ST SESS., TAX REFORM STUDIES AND PROPOSALS, PT. 3 (Comm. Print 1969) [hereinafter cited as TREAS. PROPOSALS].

3. Secretary of the Treasury Connally stated that he favored the retention of the dual tax and referred to the Treasury Proposal for a unified tax as a "staff proposal" which was never adopted by the Treasury nor by the [Johnson] Administration. N.Y. Times, Feb. 27, 1971, at 34, col. 1.

4. INT. REV. CODE of 1954, §§ 2035-38, 2040.

visions for determining severance of ownership differ from both the estate and gift tax.[5] Chairman Mills of the Ways and Means Committee, in a speech prepared for delivery to the American Bankers Association, pointed out that one of the goals of any reform would be the virtual elimination of double taxation as a result of the same transfer.[6] A realistic and neccessary addition to that goal would be a correlation of the estate, gift, and income tax provisions.

The nature of reform in this area must be considered within the framework of the present dual transfer tax system and the Treasury Proposal for a unified tax. The latter would extend the present system of taxing gifts on a cumulative basis to include death transfers.[7] Both life and death transfers would be subject to the same tax rate, approximately twenty percent of the present estate tax rate, and the tax rate at death would depend on the aggregate value not only of the value of the estate at death but also on the total aggregate value of lifetime and death transfers.[8] In addition, the proposal contains a "gross-up" feature for calculating the tax on lifetime transfers,[9] which will be explained later.

By eliminating the very considerable transfer tax savings inherent in lifetime gifts under present law, the unified tax would certainly decrease the motivation for attempting to fashion a testamentary objective into a lifetime gift. For example, the gift in contemplation of death, the classic example of one transfer causing both a gift and an estate tax to be imposed, would be virtually eliminated.[10] However, even under a unified tax the determination of the proper time when the tax will be imposed (essentially the same question under the dual

5. INT. REV. CODE of 1954, §§ 671-77

6. The speech was never delivered but the text outline was printed in the N.Y. Times, Oct. 13, 1970, at 25.

7. TREAS. PROPOSALS, *supra* note 2, at 355.

8. *Id.* at 355-56.

9. *Id.* at 355.

10. Tax avoidance under a unified tax by a gift in contemplation of death will still exist with respect to insurance as a result of the retention of the incidents of ownership test. TREAS. PROPOSALS, *supra* note 2, at 362. Therefore, the Treasury is proposing that the present treatment of insurance under INT. REV. CODE of 1954, § 2035 be retained with a modification to provide that

> in addition to lifetime transfer tax, the deathtime transfer tax will be imposed upon the portion of life insurance proceeds equal to the increase in cash value of the policy resulting from premiums paid during the 3 years preceding death plus the difference between the face amount of the policy and its cash value at date of death.

TREAS. PROPOSALS, *supra* note 2, at 362.

tax and which led to the double tax problem) must be resolved in those instances where the transferor retains either a current beneficial interest, a reversion, or some power over the beneficial enjoyment of the property

The American Law Institute Study, a five year project completed in 1968,[11] includes resolutions for the double tax problem under both a unified and dual tax system. The two proposals were necessary because the Institute was unable to reach a consensus on the adoption of either a dual or unified tax.[12] In this article an evaluation of the unified and dual tax will be made by examining the capacity of both systems to eliminate the problem of the double tax and establish an understandable set of guidelines which will enable one to predict the tax effects of routine or recurring transfer schemes. The latter goal requires some attempt at coordinating the grantor trust provisions in the income tax law, especially section 674, with the estate and gift tax provisions.

Contemplation of Death

The most obvious starting point in an exploration of the double tax problem is the gift in contemplation of death.[13] Everyone, including Chairman Mills, realizes that under a dual tax system there is no way completely to avoid this problem. The considerable transfer savings under the present law is a strong incentive for persons anticipating death to make lifetime transfers. Not only is the gift tax rate only three-quarters as high as the estate tax rate,[14] but there is no tax at all until the gift exceeds $30,000 ($60,000 for a husband and wife)[15] Even when the gifts exceed the specific exemption and the per donee annual exclusion of $3,000, the gift is taxed at the bottom of the rate schedule rather than being on top of the estate tax rate, as it would be if the property were retained until death.

Even under a unified tax system there can be a slight tax advantage in making an inter vivos gift rather than allowing that property to pass at death. It is the same advantage that exists under the present dual tax where the presumption of a gift in contemplation of death cannot be rebutted and the value of the transferred property is included in the

11. *See* note 1 *supra.*
12. ALI PROJECT, *supra* note 1, at 55-57
13. INT. REV. CODE of 1954, § 2035.
14. *Compare* INT. REV. CODE of 1954, § 2001, *with* § 2502.
15. INT. REV. CODE of 1954, §§ 2503, 2521.

gross estate. It results because a full credit for the gift tax paid is applied against the estate tax[16] without making any adjustment, in the way of a gross-up, for the fact that the gift tax previously paid has not been included in the gross estate.[17] The American Law Institute Proposal remedies this situation under the dual tax by eliminating the credit and substituting a refund.[18] In this way the taxes refunded would be included in the gross estate. The Treasury Proposal for a unified tax contains a gross-up feature that will cause the tax paid on any lifetime transfer to be determined not solely on the basis of the fair market value of the property transferred, but rather on the fair market value of the property transferred plus the amount of the federal transfer tax incurred on the transfer.[19] The American Law Institute approach under a unified tax is much more moderate; it only requires transfer taxes paid on lifetime transfers made in either of the two taxable periods prior to the transferor's death to be treated as death transfers and be taxed accordingly.[20]

It is clear that the adoption of a unified tax coupled with a gross-up feature will virtually eliminate the considerable litigation that now arises in this area of contemplation of death. This reduction of litigation alone, something that cannot be done under a dual tax, is a persuasive argument in favor of the adoption of a unified tax.

Powers to Affect Beneficial Enjoyment

Under present law, a gift tax is imposed when the transfer is complete.[21] A gift is not complete, even where the donor cannot regain any interest in the property for himself, until that time when the donor can no longer name new beneficiaries or change the interests of beneficiaries between themselves.[22] The estate tax is imposed where the donor has the power at death to affect the beneficial enjoyment of the property.[23] While the controlling question for both taxes is the same, the answer under many circumstances is not. This sharply frus-

16. INT. REV. CODE of 1954, § 2013.

17. Under the present estate tax law the assets used to pay the tax are included in the gross estate. *See* INT. REV. CODE of 1954, § 2033. The assets used to pay gift tax are not included in the value of the gift. *See* INT. REV. CODE of 1954, § 2503(a).

18. ALI PROJECT, *supra* note 1, at 45.

19. TREAS. PROPOSALS, *supra* note 2, at 355.

20. ALI PROJECT, *supra* note 1, at 45.

21. Treas. Reg. § 25.2511 (1954).

22. Treas. Reg. § 25.2511-2(c) (1954).

23. INT. REV. CODE of 1954, § 2038.

trates two common goals of any tax: predictability for routine transactions and uniform treatment for transfers that only vary in form rather than substance. The overwhelming majority of these transfers whereby some control over beneficial enjoyment is retained are made to a trust, and thus involve as a third set for guidelines to test severance of ownership, the grantor trust income tax rules referred to earlier.[24] The lack of correlation between the latter provisions and the transfer taxes cannot be justified on the grounds that trust income taxation is fundamentally different from transfer taxation because the basic factor for all is the transferor's control. In fact, in 1955 the American Law Institute drafted a tentative statute establishing a correlated scheme for grantor trust income, estate and gift taxation by which estate and gift taxation would have depended directly upon the taxability of the grantor under the income tax.[25]

The lack of correlation between the three taxes can be best illustrated by an analysis of the tax treatment of four rather routine transfers to a trust. Examples:

> *A* transfers to *T*, an unrelated party, 20 shares of stock to hold in trust and pay the income to *B*, *A*'s son, until he reaches age 35, then to pay the corpus to *B*. *A* retains the power to instruct the trustee to pay any part or all the corpus to *B* before reaching age 35. Note that *A*'s retained power is merely the power to accelerate *B*'s vested interest. This mere power to affect the time of enjoyment of an interest already vested does not prevent a gift from being complete.[26] Nor does it cause the settlor to be taxed on the trust income.[27] On the other hand, the entire value of the corpus and probably the entire value of the income interest as well will be included in the gross estate of *A* if he dies before *B* reaches 35 without having fully executed or relinquished the power.[28]
>
> *A* transfers 10 shares of stock to himself and his adult son *B* in trust for *B* for life, remainder to *D*, the nephew of *B* and grandson of *A*. *A* retains the power, in conjunction with *B*, to invade cor-

24. INT. REV. CODE of 1954, §§ 671-77

25. ALI FED. INCOME TAX STAT. § X2012(a) (Draft 10, 1955).

26. Treas. Reg. § 25.2511-2(d) (1954). "A gift is not considered incomplete, however, merely because the donor reserves the power to change the manner or time of enjoyment "

27. *See* INT. REV. CODE of 1954, § 674(b)(5)(B); Treas. Reg. § 1.674(b)-1(b)(5)(ii) (1956).

28. Lober v. United States, 346 U.S. 335 (1953); Treas. Reg. § 20.2038-1(a)(3) (1954).

pus for the benefit of *D*. Since the power over the corpus retained by *A* can only be exercised in conjunction with *B*, an adverse party, the gift is complete[29] and in addition *A* will not be taxed on the trust income.[30] On the other hand, if *A* predeceases *B*, the entire value of the property will be included in *A*'s gross estate.[31]

A declares himself trustee of 20 shares of stock for his son, *B*, for life, then to his grandchildren *D* and *E*. *A* retained the power as trustee to pay during the life of *B* the income or any portion thereof to *D* and *E* if required for educational purposes. Since the power to distribute income to *D* and *E* is held in a fiduciary capacity and subject to an ascertainable standard, the gift of income and corpus is complete[32] and no portion of the property will be included in the grantor's gross estate.[33] On the other hand, the power to control the disposition of income, even if limited by an ascertainable standard, will cause the income to be taxable to the grantor unless the power is exercisable by a trustee other than the grantor or his spouse.[34]

A transfers 20 shares of stock to *W*, his wife, in trust, the income to be distributed by *W* among *B*, *C*, or *D*, as she may determine, the remainder to *E*. There is no attempt under either estate or gift taxation to impute to the grantor powers held by another, no matter how subservient to the grantor that other party may be.[35] On the other hand, the grantor trust provisions do impute to the grantor, in varying degrees, powers held by another depending on the relationship of the holder and the extent of the power.[36] Of course, in this case the power held by the spouse causes the grantor to be taxed on the income of the trust.[37]

Some sound arguments have been advanced in support of the distinctions set forth in the above examples. However, the estate tax

29. Camp v. Comm'r, 195 F.2d 999 (1st Cir. 1950); Treas. Reg. § 25.2511-2(e) (1954).

30. Treas. Reg. § 1.672(a)-1(c) (1956) clearly indicates that *B* is an adverse party and INT. REV. CODE of 1954, § 674(a) excepts powers held in conjunction with an adverse party.

31. Helvering v. City Bank Farmers Trust Co., 296 U.S. 85 (1935); INT. REV. CODE of 1954, § 2038(a)(1); Treas. Reg. § 20.2038-1(a)(3) (1954).

32. Treas. Reg. § 25.2511-1(c) (1954). *See* Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947).

33. Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947).

34. *See* INT. REV. CODE of 1954, §§ 672-76.

35. W WARREN & S. SURRY, FEDERAL ESTATE AND GIFT TAX 406 (1961); INT. REV. CODE of 1954, §§ 2036, 2038; Treas. Reg. § 25.2511-2 (1954).

36. INT. REV. CODE of 1954, §§ 672-76.

37. INT. REV. CODE of 1954, § 674.

consequences in the first example, although the product of a Supreme Court decision, cannot be supported by anything other than an extremely literalistic reading of the statute.[38] The estate tax will not permit the recognition for tax purposes of the neutralizing effect on a power where it must be exercised in conjunction with an adverse party. This is illustrated in the second example. The result is said to be predicated upon the fear that under any other rule the transferor could easily avoid the estate tax by joining in the exercise one who would comply in spite of an adverse interest.[39] The same fear of abuse, probably regarded as acute because the power is directly related to the tax, is the obvious reason advanced for the income tax treatment in the third example, which results from a refusal to give the usual neutralizing effect to an ascertainable standard where the power to distribute income is in the grantor or his spouse. The questionable benefits derived from retaining the distinctions set forth above ought to be weighed against the considerable confusion and uncertainty inherent in even the most routine transfers.

In any event, it is obvious, after closely examining the examples set forth above, that the double tax problem in the powers area could be eliminated by simply providing that a gift will not be complete for gift tax purposes in any situation where because of a retention of a power over the beneficial interest in the property, it would be included in the grantor's gross estate. The imposition of any transfer tax could either be postponed until the grantor's death or incurred earlier if the power were exercised or relinquished. It is just as obvious that coupled with the above there should be a provision causing powers conferred by the grantor upon parties related and subservient to be imputed to the grantor. The combined effect of Resolutions 23 and 25 of the American Law Institute is a major move in that direction. These read as follows:

38. INT. REV. CODE of 1954, § 2038(a) provides that

> the value of the gross estate shall include the value of all property
> (1) [t]o the extent of any interest therein of which the decedent has at any time made a transfer . . ., where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power . . ., to alter, amend, revoke or terminate . . . .

39. Helvering v. City Bank Farmers Trust Co., 296 U.S. 85 (1935). Since 1924 the statute expressly reaches transfers if enjoyment was subject to a power to alter, amend, or revoke exercisable by the decedent alone or in conjunction with any person. Before that the rule was otherwise. Reinecke v. Northern Trust Co., 278 U.S. 339 (1929).

23. A line between completed and incompleted gifts should be definitely established, so that all lifetime arrangements would fall on one side of the line or the other, and so that there would be no area where the same transfer is subject to transfer taxation both as a lifetime transfer and a deathtime transfer, under either a dual tax system or a unified tax.

25. Under a dual tax system, a hard to complete gift rule should be adopted in the power cases which would prevent a lifetime arrangement from being a completed gift if there is a *power in anyone* to modify who takes or to *modify when a beneficiary takes*, except that an otherwise completed gift would not be incomplete if the power is in one or more persons other than the transferor and (a) is exercisable only by will or (b) such power-holder is treated as the owner of the transferred property for transfer tax purposes or (c) not more than half the power-holders are in the related or subordinate category as defined by IRC 672.[40] (Emphasis supplied).

The problems of correlation in the power area are not insoluble. If the adoption of the American Law Institute proposal could be parlayed with the acceptance of a unified position under all three taxes that any power which is either (1) subject to an ascertainable standard, (2) exercisable in conjunction with an adverse party, or (3) limited to modification of the time when the beneficiary takes shall have no tax significance, the triple standard problem, as well as the double tax problem, would in the power cases be virtually eliminated.[41] The adoption of such a proposal would also be a major step toward the elimination of the triple standard. The only appreciable difference between the estate or gift tax and sections 674 and 676 of the grantor trust provisions would be that in section 674 there is imputed to the settlor a power held by an independent trustee to add beneficiaries.[42] This position should be retained by section 674 in order to impede a proliferation of taxable entities, a subject beyond the scope of this article.

If the dual tax is replaced by a unified tax, then an easy-to-complete gift tax rule, rather than a hard-to-complete gift tax rule, should be

40. ALI PROJECT, *supra* note 1, at 45-46.

41. " or to *modify when a beneficiary takes* " would have to be removed from resolution 25.

42. *See* INT. REV. CODE of 1954, §§ 674(b)(4), (7), 676(a).

adopted in the powers cases. American Law Institute Resolution 24 reads as follows:

> 24. Under a unified tax an easy-to-complete gift rule should be adopted in the powers cases which would eliminate the significance of a power in lifetime arrangements to prevent a completed gift unless (a) the power can be exercised in favor of the transferor and (b) the power is exercisable by the transferor alone or in conjunction with one who does not have a substantial interest that would be adversely affected by the exercise of the power.[43]

The Treasury study points out that an easy-to-complete transfer rule, which it also recommends for adoption, can be made under a unified tax because, unlike the present dual tax, regarding lifetime transfers as complete does not invite any significant tax avoidance.[44]

It is true that the unified tax is a very effective method of solving the double tax problem in the powers cases. The crucial question, however, must be: Is it possible by making the modifications to the dual tax referred to above, and the others that follow, to deal just as effectively with the double tax problem and at the same time achieve a correlation with the grantor trust income tax provisions, something which is not possible under the unified tax? Such a correlation would permit a single tax standard for transfers to a trust.[45]

REVERSION

Under present law, if the transferor retains a reversion that has slightly more than a one-in-twenty chance of becoming possessory, it may cause a substantial increase in the value of his gross estate.[46] This may result even where the reversion does not descend but terminates because of his death.[47] The applicable estate tax section of the Internal Revenue Code, section 2037, provides that the gross estate

43. ALI PROJECT, *supra* note 1, at 45.

44. TREAS. PROPOSALS, *supra* note 2, at 386.

45. Under a unified tax, an easy-to-complete gift rule would be adopted in the powers cases, and the rule could never be correlated with the grantor trust provisions of INT. REV. CODE of 1954, § 674, since the guidelines there will have to be toward strict enforcement of an income tax on any grantor who retains substantial power.

46. INT. REV. CODE of 1954, § 2037.

47. The crucial time for valuing the reversion is immediately before the death of the decedent. INT. REV. CODE of 1954, § 2037(a)(2). This is so even though the survival of the decedent is required for the reversion to take effect.

includes property transfered by the decedent to the extent possession or enjoyment of the property could be obtained only by surviving the decedent and the decedent retained a reversionary interest (other than in income alone) that immediately before his death exceeded five percent of the entire value of the property

The application of the section is well illustrated by an example contained in the regulations:

> The decedent transferred property in trust with the income payable to his wife for life and with the remainder payable to the decedent or if he is not then living at his wife's death to his daughter or her estate. [48]

Commenting on this example, Leach and Logan note that

> [i]f the decedent dies prior to his wife the entire value of the property less the value of the wife's life interest will be included in his gross estate. Note that this is the result in spite of the fact that the reversionary interest was terminated when the decedent predeceased his wife. The value of the reversion is determined immediately before the transferor's death and would in this type of case probably exceed five percent of the entire value of the property Note also that the daughter's interest was only contingent upon the father predeceasing her mother; not upon the daughter surviving her father. However, the regulations evidently take the provision that a *possession* or *enjoyment* could be obtained in spite of the fact that the interest was vested only by surviving the decedent.[49]

Another example taken from Casner's *Estate Planning*[50] will further demonstrate that the complexity of section 2037 is not visible except to the arcane.

> *S* creates a trust to pay income to *A* for life; on *A*'s death to pay the principal to *S*, if *S* is then living, otherwise to *B*, if *B* is then living. At the death of *S* both *A* and *B* are living. Note that *S*

48. Treas. Reg. § 20.2037-1(e) (1954) (Ex. 3).

49. *See* B. LEACH & J. LOGAN, FUTURE INTEREST AND ESTATE PLANNING 23 (Supp. 1962) for a full discussion on the question of whether INT. REV. CODE of 1954, § 2037 is applicable where the interest will vest without surviving the decedent but enjoyment cannot take place without surviving the decedent.

50. A. CASNER, ESTATE PLANNING 215 (3d ed. 1961) (Prob. 6.28).

> has two reversionary interests, one expressed and the other implied. The implied reversion results from the requirement that *B* must survive *A*. In determining whether the five percent test is met the percentage chance of both reversionary interests becoming possessory must be tested immediately before *S*'s death and then must be totaled.[51] (Italics supplied).

In the process of the American Law Institute study six different proposals for the elimination of the double tax problem under a dual tax were considered.[52] All were aimed at fixing one time when a tax, either estate or gift, would be imposed to the exclusion of the other. The time at which the tax would be imposed varied under each alternative. These alternatives ranged from simply providing that where under present law a double tax is imposed on the same transfer that only one should be imposed[53] to the adoption of entirely new standards for fixing the time when a transfer would be complete. The new standards proposed varied, and included the adoption of 1) a rule which depends on the grantor's tax liability for the income;[54] 2) the easy-to-complete gift rule proposed originally for a unified tax[55] (with and without modifications);[56] and 3) a hard-to-complete gift rule which, as explained earlier, was adopted for the powers cases.[57]

The approach taken for the powers cases was not adopted for all situations. Rather, a combination of the above alternatives was selected by the Institute, to be applied depending on the nature of the transfer. The Institute's resolution for transfers where a reversionary interest is retained provides:

> The value of a reversionary interest retained by the transferor that is certain to become possessory and of all succeeding interests, should be considered an incomplete gift as long as such retained interest is held by the transferor, under either a dual tax system or a unified tax.[58]

51. *See* INT. REV. CODE of 1954, § 2037(a). The actuarial determinations are made by calculating the percentage chance that a person of *S*'s age will survive a person of *A*'s age and adding that to the percentage chance that *S* and *B* will predecease *A*.

52. ALI PROJECT, *supra* note 1, at 191-98 (Reporter's study of Dual Tax Systems and Unified Tax).

53. *Id.* at 196-97 (Alternative Nos. 4, 5).

54. *Id.* at 193 (Alternative No. 3).

55. *Id.* at 191 (Alternative No. 1).

56. *Id.* at 192 (Alternative No. 2).

57. *Id.* at 198 (Alternative No. 6).

58. *Id.* at 46.

When this resolution is read in conjunction with the resolution[59] which provides for a clear line between lifetime and death transfers, it appears clear that the Institute was adopting an easy-to-complete gift tax rule for the reversion cases. Under present law, the value of a reversionary interest, assuming that it can be established, is excluded from the value of the taxable gift.[60] Under the Institute Proposal there would be no exclusion except where the reversionary interest was certain to become possessory, and in that case not only the reversionary interest but all succeeding interests would be considered incomplete until such time as the interest under the reversion ended or was transfered.[61]

More importantly, the American Law Institute Proposal spells the repeal of section 2037 of the Internal Revenue Code.[62] Under the Proposal the only situation where any estate tax will result from the retention of a defeasible reversionary (one not certain to become possessory) interest is where the transferor resumes complete ownership of the property under the reversion.[63] Therefore, present law is altered not only with respect to section 2037 but also with respect to section 2033. Under section 2033, the value of a descendible but defeasible reversion is included in the gross estate.[64] Although the changes have the effect of subjecting to gift tax something which is not transfered but retained (the defeasible reversionary interest) and at the same time freeing from estate tax an interest which descends at death (a defeasible but descendible reversionary interest), this approach is preferable to retaining the present law with all of its complexities. A close examination of the apparent incongruous treatment set forth above reveals that it is essentially a matter of deciding when the transfer will be considered complete.

The retention by a transferor of a reversionary interest presents basically the same problems under a unified tax as exist under a dual tax. For that reason, the solution set forth by the American Law Insti-

59. *Id.* at 45.

60. What is retained is obviously not transferred. *See* Treas. Reg. § 25.2512-1 (1954). The taxpayer has a difficult burden in valuing the reversion. *See* Robinette v. Helvering, 318 U.S. 184 (1943); TREAS. PROPOSALS, *supra* note 2, at 386.

61. ALI PROJECT, *supra* note 1, at 46.

62. *Id.* at 118, 187 (Reporter's Study of Dual Tax Systems and Unified Tax).

63. *Id.* at 161.

64. The value of a reversionary interest certain to become possessory and all interests that follow that reversionary interest would be included in the gross estate. ALI PROJECT, *supra* note 1, at 46.

tute is the same under both systems, and the Treasury Proposal for a unified tax adopts the American Law Institute solution.[65]

JOINT INTEREST

Under present law, there is a built-in double tax problem with respect to a joint interest created by the gratuitous transfer of one of the joint owners. On the creation, a gift tax is imposed on the value of the interest transferred, and if the donor predeceases the donee the entire value of the property will be included in his gross estate.[66] The entire value of the property is included because under section 2040 of the Internal Revenue Code inclusion is determined on the basis of contributions toward the acquisition of the property, not on the basis of property interests passing at death. The contribution test requires tracing, which is often difficult and sometimes impossible.

The American Law Institute proposes only a slight change in the gift tax treatment. The change brings the creation of a tenancy by the entirety by one of the spouses into line with the creation of any other joint tenancy The proposal reads as follows:

> The value that is received by a donee-joint-owner with the right of survivorship, where the donor makes a gift at the time the joint ownership was created, should be the value of his fractional interest, whether or not the right of survivorship is destructible by the unilateral act of the donee-joint-owner, under either a dual tax or a unified tax.[67]

The only joint tenancy where the right of survivorship is not destructible by the unilateral act of any joint owner is a tenancy by the entirety. Under present law a gift made by a donor-tenant by the entirety is valued by an actuarial comparison of the life expectancy of the donor and donee tenant.[68] Under this method of valuation the younger tenant is regarded as having the most valuable interest in the tenancy The same difficult gift tax valuation problems exist where the joint tenancy is terminated and the funds divided.[69]

The American Law Institute has proposed an entirely new scheme

65. TREAS. PROPOSALS, *supra* note 2, at 386.
66. INT. REV. CODE of 1954, §§ 2511, 2040.
67. ALI PROJECT, *supra* note 1, at 12.
68. Treas. Reg. § 25.2515-2(b) (1954).
69. Treas. Reg. § 25.2515-4 (1954).

for the estate taxation of all property held jointly with the right of survivorship.

> The amount of what is transferred on the death of a joint owner should be his fractional interest, except where no gift was made at the time the joint ownership was created, under either a dual tax system or a unified tax.[70]

It will be noted that the transfer test is not extended to real property held as tenants by the entirety unless the creation of the tenancy was treated as a gift in lieu of the non-gift tax treatment available under section 2515. Otherwise, only half of the jointly held property would be subject to tax at death, in spite of the fact that no transfer tax was imposed on the creation of the tenancy.[71]

The Treasury Proposal for the treatment of concurrent interests under a unified tax is in complete accord with the American Law Institute Resolution for eliminating the double tax problem with respect to joint interests with the right of survivorship.[72] This, like the retention of reversionary interest cases presented earlier and the retention of beneficial interest cases that follow, is another area where nothing inherent in the nature of the unified tax enables the double tax problem to be solved with any more efficacy than under the dual tax.

RETENTION OF BENEFICIAL INTEREST

The double tax problem which occurs where a current beneficial interest in transferred property is retained[73] is easily eliminated under either a dual or unified tax simply by providing that such a transfer is incomplete as long as the transferor retains the current beneficial enjoyment. This solution was adopted by both the American Law Institute and the Treasury.[74] Where there is a retention of a non-current beneficial interest the tax treatment is controlled by the proposals relating to transfers where reversionary interests are retained by the transferor. In addition, the retention of a reversion in the in-

70. ALI PROJECT, *supra* note 1, at 12-14.

71. *Id.*

72. TREAS. PROPOSALS, *supra* note 2, at 375.

73. If *A* transfers property to *B* but retains a life estate, not only is the remainder interest subject to gift tax but INT. REV. CODE of 1954, § 2036 causes the entire interest in the transferred property to be included in *A*'s gross estate at death.

74. ALI PROJECT, *supra* note 1, at 46; TREAS. PROPOSALS, *supra* note 2, at 384.

come alone is treated the same as a reversion in the fee.[75] Under present law, a reversion in income only is not treated under section 2037 of the Internal Revenue Code, but under section 2036.[76] The treatment under the American Law Institute and Treasury Proposals can best be contrasted with present law by the following example.

> *T* transfers to *A* for life, then to *T* for life, remainder to *B*. Under present law the value of the property transferred less the value of the reversionary interest in *T* is subject to gift taxation.[77] The entire value of the property minus the value of *A*'s life estate will be included in the gross estate of *T*[78] Under the A.L.I. Proposal for a dual tax the entire value of the property transferred is subject to a gift tax.[79] The reversionary interest in the income is ignored because it is not certain to become possessory No part of the property will be included in *T*'s gross estate on death.[80]

If the reversion in the income in the above example becomes possessory and is transferred, it will be subject to gift tax.[81] However, there is no way an estate tax will ever be imposed, because the life interest will necessarily end on the death of the transferor. This type of transfer is so obviously testamentary that it seems strange that it escapes death tax. Although an additional gift tax is imposed on the original transfer because of the refusal to permit the gift value to be reduced by the value of the reversion, this may not be enough of an increase in tax to offset the death tax savings. The reversion of a life interest should be viewed as an aberration and treated independently from the retention of current enjoyment cases and the reversion cases.

CONCLUSION

It is this writer's opinion that a comparison of the dual tax system with the unified tax system with respect to the capacity of each to solve the double tax problems ends in a stalemate. Inherent in the uni-

75. ALI PROJECT, *supra* note 1, at 161.
76. INT. REV. CODE of 1954, § 2037
77. ALI PROJECT, *supra* note 1, at 161.
78. INT. REV. CODE of 1954, § 2036.
79. ALI PROJECT, *supra* note 1, at 161.
80. It appears clear that this will be the result where *T* predeceases *A*. In view of Resolution 23 of the American Law Institute, (*supra* note 40 and accompanying text) it would also be the result if *A* predeceased *T*
81. ALI PROJECT, *supra* note 1, at 161.

fied approach is the removal of virtually all tax incentives for the making of inter vivos gifts. On the other hand, the magnitude of the present incentives to inter vivos giving can, within the present dual system, be reduced to a tolerable level and thus the uncertainty that would necessarily accompany a change to a unified system could be avoided. A decision to modify the present dual tax in accordance with the American Law Institute Resolutions and the other slight modifications suggested in this article would not only solve the problem of double taxation but would, in addition, provide a close correlation with the grantor trust income tax provisions.

The Treasury study, which continually refers to the complexities of the dual system as a reason for urging the adoption of a unified tax, is quite misleading, because the complexities can be simplified within a dual system. The American Law Institute, on the other hand, properly focused on the issue when it stated in its final resolution:

> [T]he primary justification for changing to a unified tax system is to keep the rates on deathtime transfers by those who do not or cannot make lifetime transfers at a lower rate than would be possible under a dual tax system. [82]

If agreement cannot be reached on the vital policy questions involved in a decision to replace the dual tax with a unified tax, which is a likely possibility considering the failure of both the American Law Institute and the Treasury to reach an internal consensus, this should not impede the enactment of the modifications herein proposed under the dual tax. Everyone agrees that these reform measures are sorely needed.

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82. *Id.* at 55-57