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THE PROPER ROLE OF THE ESTATE AND GIFT TAXATION OF CLOSELY HELD BUSINESSES

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Editors' Synopsis: The authors argue that the goals of estate and gift taxation are not served by taxing closely held businesses when the recipient of the business actively participates in its operation. Further, the authors suggest that taxing closely held businesses tends to harm capital production. The authors propose an approach to estate and gift taxation that encourages productive behavior by the recipients of wealth.

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I. INTRODUCTION

The federal government imposes estate¹ and gift² taxes³ on gratuitous transfers made at death and during life by relatively wealthy people.⁴ The

¹ I.R.C. §§ 2001-2207B (1994).

² I.R.C. §§ 2501-2524 (1994).

³ For convenience, we refer to the estate tax and the gift tax collectively as "the estate and gift tax" even though transfer taxation comprises separate taxes. Although the generation-skipping transfer tax is part of this system, this tax is not central to our thesis.

⁴ Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L.J. 283, 299 (1994) (referring to "the very wealthy families who are the only ones paying" estate taxes). I.R.C. § 2001, which sets out the rate schedule for estate and gift taxation, imposes a tax of \$192,800 on estates and "adjusted lifetime gifts" that total \$600,000 in value. This tax, however, is precisely offset by the "unified credit" of I.R.C. § 2010(a). Moreover, I.R.C. §§ 2056, 2523 provide an unlimited deduction for most interspousal transfers. Thus, a spouse with \$1,200,000 may give \$600,000 to the other spouse. Both may then avail themselves of their individual unified credits, leaving neither with any transfer tax liability. Hence, a de facto minimum taxable estate size for married couples is at least \$1,200,000, but competent planning allows the tax-free transfer of even more wealth by a married couple. Cf. John E. Donaldson, *The Future of Transfer Taxation: Repeal, Restructuring and Refinement, or Replacement*, 50 WASH. & LEE L. REV. 539, 546-48 (1993) (discussing other, more sophisticated planning techniques); George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161 *passim* (1977) (describing federal transfer taxes as "voluntary").

rate of taxation on these transfers is high,⁵ and, without proper estate planning, the taxes can claim a large portion of any taxable transfer. The transfer taxes are particularly burdensome, however, for the recipients of interests in closely held businesses. These interests are often difficult to value,⁶ and their owners may face liquidity problems because a ready market for interests in closely held businesses does not exist.⁷ Congress has partially responded to the concerns of owners of closely held businesses with special provisions in the Internal Revenue Code [hereinafter I.R.C. or Code]. These provisions deal with some unusual valuation situations,⁸ allow for installment payments of the estate tax,⁹ and permit sale or exchange treatment for certain redemptions of stock¹⁰ following a decedent's death.¹¹

Members of Congress have proposed even more lenient treatment of closely held businesses under the estate tax¹² because of its perceived harshness and its potential to force the liquidation of businesses.¹³ Leniency may be improvident, however, if the only problems facing closely held businesses under the estate tax are steep rates and illiquidity. The rates under I.R.C. § 2001 are no higher for closely held enterprises than they are for any other form of wealth, and the deferral allowances of the Code¹⁴ should solve true liquidity problems.

⁵ Compare I.R.C. § 2001(c) (1994) (imposing a maximum marginal rate of 55% on the taxable estate) with I.R.C. § 1 (1994 & Supp. 1996) (imposing a maximum marginal rate of 39.6% on income).

⁶ See Zinichi Shishido, *The Fair Value of Minority Stock in Closely Held Corporations*, 62 FORDHAM L. REV. 65, 65 (1993); see also *infra* Part II.E (discussing valuation difficulties facing closely held businesses).

⁷ See Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 273-77 (1986).

⁸ See I.R.C. § 2032A (1994); see generally *infra* Part II.D.1. (discussing § 2032A).

⁹ See I.R.C. § 6166 (1994); see generally *infra* Part II.D.2. (discussing § 6166).

¹⁰ A redemption occurs when a corporation buys its own stock from a shareholder. The issue is whether the Code deems the transaction to be a sale of stock or a dividend. See *infra* notes 82-84 and accompanying text.

¹¹ See I.R.C. § 303 (1994); see generally *infra* Part II.D.3. (discussing § 303).

¹² Cf. 141 CONG. REC. S14883-07, S14897 (1995) (proposing an exclusion from estate taxation of \$1.5 million and 50% above that amount of a closely owned business under certain circumstances); 143 CONG. REC. S163-02, S176 (1997) (proposing the same).

¹³ See 141 CONG. REC. S14883-07, S14884 (1995) ("[M]any times these enterprises are literally forced out of business because of the imposition of the estate tax.").

¹⁴ See *infra* Part II.D.2. (discussing I.R.C. § 6166).

Perhaps closely held businesses deserve greater leniency under the estate and gift tax because taxing the transfer of closely held businesses does not further the goals of wealth transfer taxation. One important goal of taxing wealth transfers is decreasing inherited wealth, thereby encouraging beneficiaries of these transfers to engage in productive work.¹⁵ What if the recipient of an interest in a closely held business intends to participate actively in the business? If so, the recipient fulfills the goal of encouraging productive work even if the tax is not imposed. No tax, or a diminished tax in this situation, may be beneficial because the tax generates little revenue.¹⁶ Moreover, the tax may deter the production of capital.¹⁷

This Article argues that encouraging productive work by recipients of wealth may be the only goal of the estate and gift tax that is both achievable and economically sound.¹⁸ Taxing the transfer of closely held businesses in which the recipients will be active participants not only fails to further this goal, but also detrimentally affects capital production.

Part II of this Article outlines the present system of taxing wealth transfers and describes special provisions applicable to closely held businesses. Part II also highlights many of the problems with the application of the present system to closely held businesses. Part III catalogues several justifications for taxing wealth transfers. It concludes that encouraging productive work by recipients of wealth is the only economically sound goal, and that it is the only goal that the present system successfully accomplishes. Part IV builds on this foundation by analyzing the treatment of closely held businesses under the present system. It shows that interests in closely held businesses are theoretically distinct from other forms of wealth and that this difference justifies a reduction of transfer taxation of these interests. Indeed, taxing them encourages the donor to

¹⁵ See McCaffery, *supra* note 4, at 320-21; Mark L. Ascher, *Curtailing Inherited Wealth*, 89 MICH. L. REV. 69, 99 (1990) ("Great wealth confers tremendous disincentives to work.").

¹⁶ See Donaldson, *supra* note 4, at 542-43; BORIS I. BITTKER & ELIAS CLARK, *FEDERAL ESTATE AND GIFT TAXATION* 1 (6th ed. 1990) ("The taxes that are the subject of this book are not important sources of government revenue.").

¹⁷ MICHAEL J. BOSKIN, *AN ECONOMIST'S PERSPECTIVE ON ESTATE TAXATION* 62-63, in *DEATH, TAXES AND FAMILY PROPERTY* 56 (Edward C. Halbach, Jr. ed., 1977).

¹⁸ See *infra* Part III.D.

engage in inefficient behavior, which is not offset by any gains from encouraging the donee's efficient behavior.

II. OVERVIEW OF FEDERAL ESTATE AND GIFT TAXATION

This overview highlights the basic operation of the estate and gift tax, emphasizes the application of the tax to closely held businesses, and demonstrates a few of the incentives for taxpayers that the tax creates. This discussion establishes the starting point for finding the proper goal of the estate and gift tax, a topic explored further in Part III.

A. The Estate Tax

The estate tax provisions of the Code define the decedent's gross estate by its value as of the decedent's death¹⁹ or six months afterwards if the executor so elects.²⁰ This value is "of all property, real or personal, tangible or intangible, wherever situated,"²¹ but only "to the extent of the interest therein of the decedent at the time of his death."²² In short, the gross estate equals the value of the decedent's interest in property at death or six months afterwards.

The Code imposes an estate tax, however, only upon the decedent's taxable estate,²³ which is the decedent's gross estate less certain deductions.²⁴ The most prominent among these deductions is the marital deduction, which allows for an unlimited deduction from the gross estate for

¹⁹ See I.R.C. § 2031(a) (1994).

²⁰ See I.R.C. § 2032(a) (1994). Section 2032(c) limits the availability of this election to situations in which the transfer tax burden will be reduced. The purpose of this limitation is to prevent executors from using the election to obtain a higher income tax basis for the decedent's property in situations in which the higher value will produce no additional transfer taxes. See *infra* Part II.C.

²¹ See I.R.C. § 2031(a); see also §§ 2035-2038, 2041 (1994) (including in the gross estate certain lifetime transfers).

²² See I.R.C. § 2033 (1994).

²³ See I.R.C. § 2001(a) (1994). The executor of the estate is responsible for actually paying the tax. See I.R.C. § 2002 (1994).

²⁴ See I.R.C. § 2051 (1994).

most bequests to a surviving spouse.²⁵ The Code also provides an unlimited deduction for bequests to charities²⁶ and allows other deductions for casualty losses,²⁷ as well as for various other expenses, indebtedness, and taxes.²⁸

I.R.C. § 2001 imposes the estate tax on the decedent's taxable estate.²⁹ In most cases only those estates worth more than \$600,000 have any potential estate-tax liability because of the unified credit.³⁰ The Code provides other credits for state death taxes³¹ and foreign death taxes.³² Thus, the net tax liability of the estate is its gross liability under I.R.C. § 2001, less any applicable credits.

B. The Gift Tax

"A tax . . . on the transfer of property by gift"³³ is the subject of the gift tax provisions of the Code. The Code imposes this tax on the donor's taxable gifts,³⁴ which the Code defines as total gifts less certain deductions.³⁵ The Code values these gifts by reference to the date of the gift.³⁶

The deductions from the donor's gifts mirror some of the deductions from a decedent's gross estate.³⁷ Donors may deduct most charitable³⁸ and spousal gifts³⁹ from their total gifts when computing taxable gifts.⁴⁰

²⁵ See I.R.C. § 2056 (1994).

²⁶ See I.R.C. § 2055 (1994 & Supp. 1996).

²⁷ See I.R.C. § 2054 (1994).

²⁸ See I.R.C. § 2053 (1994).

²⁹ See I.R.C. § 2001(b)(1)(A) (1994). I.R.C. § 2001 actually imposes the tax on the sum of the decedent's taxable estate and the value of her "adjusted taxable gifts." See also *infra* Part II.B. (discussing the gift tax).

³⁰ See I.R.C. § 2010(a) (1994).

³¹ See I.R.C. § 2001 (1994).

³² See I.R.C. § 2014 (1994).

³³ See I.R.C. § 2501(a)(1) (1994).

³⁴ See I.R.C. § 2502(a) (1994).

³⁵ See I.R.C. § 2503(a) (1994).

³⁶ See I.R.C. § 2512(a) (1994).

³⁷ See *supra* notes 25-26 and accompanying text (describing, among other things, the marital and charitable deductions).

³⁸ See I.R.C. § 2522(a) (1994 & Supp. 1996).

³⁹ See I.R.C. § 2523(a) (1994).

⁴⁰ See I.R.C. § 2503(a) (1994).

Moreover, the Code excludes some donative transfers from the donor's gifts for gift tax purposes. Importantly, it grants the donor a \$10,000 exclusion for gifts per donee during each calendar year,⁴¹ and grants the donor an unlimited exclusion for certain educational and medical expenses paid on behalf of third parties.⁴²

Donors compute their gift tax liability under the estate tax schedule,⁴³ and the tax is cumulative. Donors may take only one trip through the progressive rate schedule rather than beginning at the bottom of the schedule at its lower rates each year.⁴⁴ Moreover, the gift tax liability is reduced to the extent of the unified credit against gift taxes,⁴⁵ which allows a donor to make up to \$600,000 in lifetime gifts without incurring any gift tax liability.⁴⁶

The combined rate schedules⁴⁷ and credits for the estate tax and the gift tax⁴⁸ substantially unify the estate and gift tax regimes. Nonetheless,

⁴¹ See I.R.C. § 2503(a) (1994). For example, a person with four children may give each of them \$10,000 annually without facing any gift tax liability for the transfers. Moreover, I.R.C. § 2513 allows a husband and wife to elect to treat all of their gifts as made one-half by each. See I.R.C. § 2513(a)(1) (1994). Thus, under this "split gift" rule, one spouse could transfer \$20,000 annually to each donee without either spouse facing any gift tax liability as long as the other spouse transferred nothing else to these donees. An important limitation on these annual exclusion gifts is that they must be of a present interest in property to qualify.

⁴² See I.R.C. § 2503(e) (1994).

⁴³ See I.R.C. § 2502(a) (1994).

⁴⁴ Every year the donor first computes her liability based on the aggregate of her lifetime taxable gifts including taxable gifts made during the current year. See I.R.C. § 2502(a)(1) (1994). Next, she computes her liability on the aggregate of her lifetime taxable gifts excluding taxable gifts made during the current year. See I.R.C. § 2502(a)(2) (1994). The difference constitutes her gift tax liability for the current year. See I.R.C. § 2502(a) (1994). This method of computation buttresses the progressive nature of the gift tax.

⁴⁵ See I.R.C. § 2505(a) (1994).

⁴⁶ See *supra* note 4.

⁴⁷ See I.R.C. § 2001(c) (1994).

⁴⁸ Using the gift tax credit under I.R.C. § 2505(a) effectively reduces the available estate tax credit under I.R.C. § 2010(a). I.R.C. § 2010(a) does not, however, contain any language to effect this reduction. See I.R.C. § 2010(a) (1994). I.R.C. § 2001(b)(2) decreases the amount of estate tax liability by the amount of gift tax "which would have been payable" under the present schedule on lifetime gifts. The gift tax credit decreases the amount of gift tax "which would have been payable," thus decreasing the reduction

important differences between the two remain. The Code demonstrates a preference for lifetime gifts not only by providing for the \$10,000 annual exclusion,⁴⁹ but also by utilizing different mechanics for computing the gift tax and the estate tax. Because of these different mechanics, the gift tax imposes a lower effective rate than does the estate tax on identical transfers,⁵⁰ even though the nominal rates are the same. The income tax, however, partially offsets this incentive for inter vivos giving.⁵¹

C. Related Income Tax Provisions

I.R.C. § 102(a) flatly states that "[g]ross income does not include the value of property acquired by gift, bequest, devise, or inheritance."⁵² Nonetheless, the recipient of such a transfer must pay income tax on the postgift income that arises from the transferred property.⁵³

A recipient of property by a gratuitous transfer must have a tax basis in the property to determine gain upon subsequent sale. This basis differs, however, depending on whether the transfer was testamentary or inter vivos. If testamentary, then the recipient's basis is generally the fair market value of the property as of the decedent's death.⁵⁴ If inter vivos, however, then the recipient's basis is generally the lesser of the pre-gift basis and the fair market value.⁵⁵

from the estate tax liability. See I.R.C. § 2001(b)(2) (1994).

⁴⁹ See *supra* note 41 and accompanying text.

⁵⁰ Michael A. Livingston, *Congress, the Courts, and the Code: Legislative History and the Interpretation of Tax Statutes*, 69 TEX. L. REV. 819, 852 n.148 (1991). Essentially, the estate tax "taxes the tax," whereas the gift tax does not. Hence a donor may pay the gift tax resulting from a lifetime gift without incurring additional gift tax liability. In contrast, an estate pays estate tax even on the portion of the estate used to pay the estate tax; this is similar to the operation of the income tax.

⁵¹ See *infra* Part II.C; see also *infra* notes 109-15 and accompanying text (discussing the coordination between income tax basis rules for gratuitous transfers and the taxation of the transfers).

⁵² I.R.C. § 102(a) (1994).

⁵³ See I.R.C. § 102(b) (1994). Subchapter J of the Code provides a comprehensive scheme for the income taxation of trusts, estates, and beneficiaries thereof. See generally I.R.C. §§ 671-92 (1994) (taxing the income of trusts and estates).

⁵⁴ See I.R.C. § 1014(a)(1) (1994). See also I.R.C. § 1014(b) (1994) (enumerating the testamentary transfers to which the step-up-in-basis rule applies).

⁵⁵ See I.R.C. § 1015(a) (1994).

D. Estate and Gift Tax Provisions for Closely Held Businesses

The Code contains a handful of special provisions that apply to closely held businesses. The most important of these are the valuation rules of I.R.C. § 2032A, the estate tax deferral provisions of I.R.C. § 6166, and the corporate redemption rules of I.R.C. § 303. All of these provisions, however, have significant deficiencies that limit their effectiveness in relieving the estate tax burden for owners of closely held businesses. Moreover, these provisions have no application to inter vivos transfers.

1. Section 2032A

The value of the gross estate is usually its fair market value,⁵⁶ which is generally based on the property's "highest and best use."⁵⁷ Under I.R.C. § 2032A, however, the executor of an estate may make a special valuation election for "qualified real property . . . used as a farm for farming purposes or in another trade or business."⁵⁸ The election allows the executor to value the property on the basis of its actual use rather than its highest and best use.⁵⁹ For the estate to avail itself of this election, the deceased owner (or a member of the owner's family) must "materially participate in the operation of the farm or other business."⁶⁰ Because the owner of a closely held business often materially participates in the operation of the business, I.R.C. § 2032A has the potential to provide a substantial discount⁶¹ for the valuation of interests in closely held businesses.

The technical requirements of I.R.C. § 2032A,⁶² however, often limit its usefulness to the estate of the deceased owner of a closely held business.

⁵⁶ See I.R.C. §§ 2031-32 (1994).

⁵⁷ See Michael F. Beausang et al., *Valuation: General and Real Estate*, 830 TAX MGT. PORTFOLIO at A-26 (1995).

⁵⁸ Treas. Reg. § 20.2032A-3(a) (1996).

⁵⁹ See *id.*

⁶⁰ *Id.*

⁶¹ The maximum reduction in value available under I.R.C. § 2032A is \$750,000. See I.R.C. § 2032A(a)(2) (1994).

⁶² I.R.C. § 2032A is one of the longest of the Internal Revenue Code estate tax provisions, and its technical complexities are legendary. See ROBERT B. STEPHENS, ET AL., *FEDERAL ESTATE AND GIFT TAXATION* ¶ 4.04[2] (7th ed. 1997) (describing I.R.C. § 2032A as "a very intricate piece of legislation").

To qualify under I.R.C. § 2032A, at least 25% of the value of the gross estate must consist of real property satisfying the qualified use requirements.⁶³ For many closely held businesses other than farming operations, real estate constitutes a relatively small portion of its total value. In addition, the use value of real property in a business other than a farming operation is likely to equal its fair market value because the property is probably in its highest and best use. In this case, I.R.C. § 2032A provides no valuation relief. Furthermore, even when the estate satisfies the requirements of I.R.C. § 2032A, any valuation adjustment applies to the real property—not to other valuable assets of the business. For these reasons, I.R.C. § 2032A affords little practical estate tax relief for most owners of closely held businesses, other than farms.

2. *Section 6166*

The executor of an estate generally must pay taxes when the estate tax return is due,⁶⁴ which is nine months after the decedent's death.⁶⁵ Under I.R.C. § 6166, the executor may obtain an extension of time to pay estate taxes "[i]f the value of an interest in a closely held business . . . exceeds 35 percent of the adjusted gross estate."⁶⁶ The ratio of the value of the closely held business to the amount of the adjusted gross estate determines the maximum amount of estate tax to which the extension may apply.⁶⁷ The estate may begin paying the extended tax five years after it would otherwise be due,⁶⁸ and may do so in two to ten equal, annual installments.⁶⁹ If the maximum deferral period is selected, the final installment of estate taxes will not be due until fourteen years⁷⁰ after the ordinary date for paying estate taxes.

⁶³ See I.R.C. § 2032A(b)(1)(B) (1994).

⁶⁴ See I.R.C. § 6151(a) (1994).

⁶⁵ See I.R.C. § 6075(a) (1994).

⁶⁶ See I.R.C. § 6166(a)(1) (1994).

⁶⁷ See I.R.C. § 6166(a)(2) (1994).

⁶⁸ See I.R.C. § 6166(a)(3) (1994).

⁶⁹ See I.R.C. § 6166(a)(1) (1994).

⁷⁰ The latest payment date for the first installment is five years after the date prescribed by I.R.C. § 6151(a). See I.R.C. § 6166(a)(3) (1994). The tenth installment will occur nine years after the first. Hence, the maximum deferral period is 14 years.

Unlike I.R.C. § 2032A, I.R.C. § 6166 does not reduce the estate tax burden applicable to interests in closely held businesses. By design, I.R.C. § 6166 addresses liquidity concerns. The legislative history describes this purpose as follows:

This provision is primarily designed to make it possible to keep together a business enterprise where the death of one of the larger owners of the business results in an imposition of a relatively heavy estate tax. Where the decedent had a substantial portion of his estate invested in the business enterprise, under existing law this may confront the heirs with the necessity of either breaking up the business or of selling it to some larger business enterprise, in order to obtain funds to pay the federal estate tax Therefore, although not removing any federal estate tax in these cases, your committee hopes that by spreading out the period over which the estate tax may be paid, it will be possible for the estate tax in most cases to be paid for out of the earnings of the business, or at least that it will provide the heirs with time to obtain funds to pay the federal estate tax without upsetting the operation of the business. Your committee believes that this provision is particularly important in preventing corporate mergers and in maintaining the free enterprise system.⁷¹

Thus, the ostensible purpose of the provision is to defer estate taxes but not to forgive them. In many respects, I.R.C. § 6166 provides a benefit to the estate no more valuable than a loan from a commercial lender.⁷²

⁷¹ H.R. REP. NO. 2198, 85th Cong., 2d Sess. (1958), 1959-2 C.B. 709, 713 (discussing the original version of I.R.C. § 6166, enacted in 1958 as part of the Technical Amendments Act of 1958, Pub. L. No. 85-866, § 206). I.R.C. § 6166 was subsequently modified. Tax Reform Act of 1976, Pub. L. No. 95-455, § 2004(a); Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 422; Tax Reform Act of 1984, Pub. L. No. 98-369, § 1021.

⁷² In one significant respect, a commercial loan may prove more valuable to the estate. The interest payments under I.R.C. § 6166 may be deducted for estate tax purposes under I.R.C. § 2053, which, in general, allows a deduction for expenses of administration. I.R.C. § 2053(a)(2) (1994). Currently, however, the I.R.C. § 6166 interest obligation may be deducted for estate tax purposes only as the obligation is incurred. *See* Rev. Proc. 81-27, 1981-2 C.B. 548 (requiring the periodic filing of revised estate tax returns). In the case of a commercial term loan with no pre-payment option, an

In only one limited sense does I.R.C. § 6166 forgive any tax: a preferential 4% interest rate applies to a portion of the deferred estate taxes.⁷³ Under I.R.C. § 6601(j), a 4% interest rate applies to an amount equal to the lesser of (1) the total estate taxes deferred or (2) the estate taxes attributable to the first \$1,000,000 of closely held business property.⁷⁴ In most cases, the estate tax attributable to the first \$1,000,000 of business property is \$153,000 (\$345,800 reduced by the available unified credit). The value of this tax benefit for a particular taxpayer depends on the difference between the 4% interest rate and the otherwise applicable interest rate on deferred taxes (which, under I.R.C. § 6621, is the federal short-term rate plus 3%).⁷⁵ Assuming an otherwise applicable interest rate of 8%, the value of the benefit of the lower 4% rate is \$38,769.36.⁷⁶ For a taxable estate worth \$3,000,000 or more, in which case the marginal estate tax rate is 55%,⁷⁷ the savings correspond to a \$70,489.74⁷⁸ reduction in the value of the estate for tax purposes. Thus, based on an 8% discount rate, the most that I.R.C. § 6166 permits is tax forgiveness⁷⁹ for a \$70,489.74 portion of

estimate of the interest to be incurred throughout the payment period may be deducted up front on the original estate tax return. See *Estate of Graegin v. Commissioner*, 56 T.C.M. (CCH) 387 (1988). The reason for this difference in treatment is that, under I.R.C. § 2053, an expense is deductible only if the amount of the expense "is ascertainable with reasonable certainty and will be paid. No deduction may be taken upon the basis of a vague or uncertain estimate." Treas. Reg. § 20.2053-1(b)(3) (as amended in 1972). The position of both the Internal Revenue Service [hereinafter Service] and the United States Tax Court is that the amount of interest payable under I.R.C. § 6166 cannot be determined with reasonable certainty until the interest is actually paid because the taxpayer may at any time voluntarily or involuntarily prepay the deferred tax. See *Estate of Bailly v. Commissioner*, 81 T.C. 246 (1983); see also Rev. Proc. 81-27, 1981-2 C.B. 547 (setting forth the procedure for deducting interest as it accrues).

⁷³ See I.R.C. § 6601(j) (1994).

⁷⁴ *Id.*

⁷⁵ See I.R.C. § 6621(a) (1994 & Supp. 1996).

⁷⁶ This number is the net present value of a \$153,000 loan bearing interest at 4%, with the longest term to maturity under I.R.C. § 6166, assuming a discount rate of 8%.

⁷⁷ See I.R.C. § 2001(a) (1994).

⁷⁸ This number is \$38,769.36 divided by 0.55, which is the highest marginal estate tax rate.

⁷⁹ Using the I.R.C. § 6601(j) interest rate as a means of effecting estate tax relief for closely held businesses is unsatisfying for several reasons. First, assuming that it is appropriate to tax certain closely held businesses more favorably than other interests, see *infra* Part II.D.3., granting that favorable treatment through I.R.C. § 6166 affords favorable treatment to certain interests that arguably should not be treated favorably and also denies favorable treatment to interests that should be treated favorably. For exam-

the closely held business interest.⁸⁰ Furthermore, even the modest savings associated with the 4% interest rate are unavailable if the closely held business interest is represented in part by stock in a holding company.⁸¹

3. Section 303

A redemption occurs when a corporation buys its stock from a shareholder in exchange for property.⁸² The tax treatment of the redemption depends upon I.R.C. § 302. The Code treats some redemptions as sales of stock⁸³ and other redemptions as distributions, which are usually

ple, the provisions of I.R.C. §§ 6166, 6601(j) are available whether or not the recipients of the property are active participants in the closely held business. If a proper goal of the transfer tax system is to increase the labor force participation of the inheritors of wealth, *see infra* Part II.D.3., then it is not proper to grant the favorable treatment of I.R.C. § 6601(j) to recipients of closely held businesses who do not participate in the operation of the business. Second, the benefits of I.R.C. §§ 6166, 6601(j) will be unavailable for certain closely held businesses that should receive favorable treatment under the estate tax laws. For example, an estate that fails to satisfy the 35% requirement of I.R.C. § 6166 (a)(1) will receive no estate tax relief whatsoever, notwithstanding that it may make economic sense to tax the estate favorably due to ownership of a closely held business. Finally, the ostensible purpose of the I.R.C. § 6601(j) preferred interest rate is to relieve the liquidity concerns of small, closely held businesses. *See* STAFF OF JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 94th Cong., 2d Sess., 547 (1976). Professor Gutman observes, however, that eligibility under I.R.C. § 6601(j) "is not determined by the size of the business or its cash-generating potential." Harry L. Gutman, *Reforming Federal Wealth Transfer Taxes after ERTA*, 69 VA. L. REV. 1183, 1263 (1983). The preferential interest rate thus provides a windfall to estates without liquidity concerns. *Id.* at 1263-64.

⁸⁰ Proposed legislation would reduce the I.R.C. § 6601(j) interest rate from 4% to zero. *See* AMERICAN FAMILY TAX RELIEF ACT, 143 CONG. REC. S183, 105 Cong., 1st Sess. § 304 (granting a \$153,000 interest-free loan to any estate with a \$1,000,000 closely held business interest that qualifies under I.R.C. § 6166).

⁸¹ *See* I.R.C. § 6166(8)(A)(iii) (1994).

⁸² *See* I.R.C. § 317(b) (1994).

⁸³ *See* I.R.C. § 302(a) (1994). The amount taxable upon a sale is the amount realized over the adjusted basis of the property. *See* I.R.C. § 1001 (1997). If the stock was a capital asset, then the gain is subject to a maximum 28% rate. *See* I.R.C. § 1(h) (1997).

taxable as dividends.⁸⁴ The taxpayer usually prefers treatment as a sale or exchange.⁸⁵

I.R.C. § 303 modifies the normal test for determining whether a distribution made by a corporation is taxable as a sale or exchange of stock or as ordinary income. Under I.R.C. § 303(a), a distribution of property to a shareholder in redemption of stock that is includible in a decedent's estate is taxed as a sale of stock rather than as a dividend to the extent of estate, inheritance, and other transfer taxes, as well as certain funeral and administration expenses.⁸⁶ I.R.C. § 303 provides a mechanism for removing cash or other property from a corporation on a tax efficient basis if the property is needed to pay estate taxes or other expenses incurred at death.

I.R.C. § 303(b) limits the availability of this special treatment.⁸⁷ The most important limitation is that the value of the decedent's stock ownership interest must exceed 35% of the excess of the value of the gross estate over the sum of the amounts allowable to the estate for estate tax deductions under I.R.C. §§ 2053, 2054.⁸⁸ If the decedent's estate includes stock in two or more corporations of which 20% or more of the value of the outstanding stock is included in the gross estate, the stock of all corporations involved is treated as the stock of a single corporation for purposes of applying the 35% limitation.⁸⁹ These percentage limitations substantially restrict the availability of I.R.C. § 303 treatment.

⁸⁴ See I.R.C. §§ 302(d), 316 (1994). If the redemption is treated as a dividend, then the entire amount is included in gross income and subject to a maximum 39.6% rate. See I.R.C. § 301(c)(1) (1994).

⁸⁵ Cf. *supra* notes 83-84 (distinguishing between exchanges and dividends).

⁸⁶ See I.R.C. § 303(a) (1994).

⁸⁷ See I.R.C. § 303(b) (1994).

⁸⁸ See I.R.C. § 303 (b)(2)(A) (1994). I.R.C. § 303(b)(2)(A) refers to "allowable" deductions. Thus, for purposes of this limitation, the I.R.C. §§ 2053, 2054 expenses need not be actually deducted on the estate tax return. For example, expenses of administration that are deducted on the income tax return for the estate and, accordingly, are not eligible for deduction on the estate tax return are nevertheless taken into account for purposes of the I.R.C. § 303(b)(2)(A) limitation. See I.R.C. § 642(g) (1994 & Supp. 1996).

⁸⁹ See I.R.C. § 303(b)(2)(B) (1994).

Another significant limitation is that I.R.C. § 303 treatment is available only to the extent that the redeeming shareholder's interest in the decedent's estate is reduced by estate, inheritance, or death taxes, or by funeral or administration expenses. This limitation is a significant trap for the unwary. For example, if a decedent's stock is distributed as part of a pre-residuary disposition under the will, the pre-residuary gift will generally bear no portion of the taxes and administration expenses,⁹⁰ and the benefits of I.R.C. § 303 will accordingly be unavailable. Furthermore, in the typical estate plan for a married couple, under which all estate taxes are deferred until the death of the surviving spouse, the benefits of I.R.C. § 303 at the death of the first spouse will be minimal because the only eligible charges to the I.R.C. § 303 property will be funeral and administration expenses.

E. Valuation Difficulties Facing Closely Held Businesses

Interests in closely held businesses are difficult to value.⁹¹ The valuation difficulties are primarily attributable to the lack of a market for the interest (particularly if it is a minority interest) and the lack of comparable businesses for which valuation information is readily available. The difficulties increase when the principal of the business has died, because the historical earnings of the business may no longer be relevant to current value.

These valuation difficulties create numerous practical problems for the small business owner who wishes to transfer property during life or at death. If the owner transfers the interest during life without accurate valuation, the owner or her successors face potential liability for gift taxes, penalties, and interest. Even tax-free gifts that deplete the donor's unified credit present valuation difficulties. If the donor inaccurately values the gift, this inaccuracy continues into the donor's estimation of her remaining unified credit and may result in the unanticipated imposition of gift taxes for

⁹⁰ A typical will charges the payment of death taxes and administration expenses to the residue of the estate. Thus, in most cases a pre-residuary disposition would not satisfy the requisites of I.R.C. § 303(b)(2)(B) (1994).

⁹¹ See Shishido, *supra* note 6, at 65; JOHN A. BOGDANSKI, *FEDERAL TAX VALUATION* ¶ 1.02 (1996).

later transfers.⁹² Moreover, the passage of time does not prevent the Service from challenging this inaccuracy in the remaining unified credit. That is, no statute of limitations prevents the Service from arguing for a higher tax liability on current transfers due to past inaccuracies in determining the remaining unified credit amount.⁹³

The inability to obtain accurate business valuations affects the owner's estimation of estate taxes that will be due at death. If the owner wishes to transfer the business interest at death, it may be impossible to estimate accurately the funds that will be needed to pay the attendant estate taxes. Until recently, buy-sell agreements could fix the value of a business for estate tax purposes under certain circumstances. The enactment of I.R.C. § 2703 in 1990 significantly curtailed the usefulness of this technique for most intra-family business transfers.⁹⁴

F. Summary

The gift tax on inter vivos transfers allows for an annual exclusion and imposes a lower effective rate than the estate tax imposes on testamen-

⁹² Suppose *A* has her full \$600,000 unified credit amount. She makes a gift to *B*, and the gift does not qualify for the annual exclusion. On her gift tax return, *A* values the gift at \$100,000, but the Service could successfully argue that its true value is \$150,000. Under *A*'s erroneous view, she has \$500,000 remaining in her unified credit amount. Under the Service's correct view, she has only \$450,000. If, in a later year, *A* makes a gift of \$500,000, she will owe gift taxes on \$50,000, notwithstanding that the earlier gift was returned at \$100,000. See I.R.C. § 2504(c) (1994) (stating that the value reported on the earlier return is binding on a later return filed after the statute of limitations has run on the earlier return only if gift taxes actually were paid on the earlier return, and the consumption of unified credit is not considered payment of taxes). *A*'s mistake on the earlier return not only affects her ability to make future tax-free gifts in excess of \$450,000, but also affects the ability of her estate to determine her estate tax liability with accuracy.

⁹³ See I.R.C. § 2504(c) (1994). Again, an example may clarify this point. Under the previous footnote, *A* inaccurately valued a gift at \$100,000, whereas the true value was \$150,000. Suppose *A* dies twenty years later without having made any gifts in the interim, and her taxable estate is worth \$500,000. The Service could argue that *A*'s estate must pay tax on \$50,000. That is, no statute of limitations binds the Service to *A*'s estimate that her earlier gift was worth only \$100,000.

⁹⁴ See I.R.C. § 2703 (1994) (stating that the value of property is determined without regard to agreements concerning price or restrictions on the right to sell).

tary transfers. Thus, donors have an incentive to transfer wealth pursuant to a series of small lifetime gifts rather than pursuant to a single testamentary transfer. The income tax, however, prefers testamentary transfers by increasing the basis only in testamentary transfers. Finally, the Code includes several provisions that reduce some of the hardships of the estate and gift tax on closely held businesses, although none of the provisions affords significant relief. Furthermore, although these provisions reduce some of the costs associated with the death of a closely held business owner, they fail to address in a satisfactory manner the appropriate taxation of the closely held business interest itself. The interest should be taxed in the first place only if doing so furthers the legitimate goals of the transfer tax system.

III. ESTATE AND GIFT TAXATION GOALS

The goals of federal transfer taxation are central to this Article. These goals determine the proper transfer taxation of interests in closely held businesses. Commentators have proposed the following goals: generating revenue, supplementing the income tax, and promoting egalitarian principles. This Article does not dispute the importance of these goals; rather, it demonstrates that neither the present transfer tax system nor any realistic alternative to it accomplishes these goals. This Article, however, develops an additional goal—the transfer tax system should minimize the harmful effects of gratuitous transfers upon donees' work efforts.

A. Generating Revenue

The estate and gift tax does not produce significant revenues for the federal government.⁹⁵ The amount the government collects from this tax is

⁹⁵ See BITTKER & CLARK, *supra* note 16, at 1; Donaldson, *supra* note 4, at 543; McCaffery, *supra* note 4, at 300-04; Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 259, 269-70 (1983); cf. Ascher, *supra* note 15, at 72-73 (describing the underutilization by the government of estate and gift taxation to produce revenue).

a relatively small percentage of its total revenues.⁹⁶ Although the government raised \$11.5 billion from this tax in 1990, this amount represented only 1.12% of its total revenue and only 0.213% of the gross domestic product.⁹⁷

This sum is even more insignificant in light of the governmental costs of administering the tax. Professor John E. Donaldson observes that the tax "requires an inordinate amount of attention at the highest levels of government, especially in relation to the relative insignificance of the revenues generated."⁹⁸ Moreover, tax planning and litigation are costly to taxpayers and occupy the talents and energy of a substantial portion of the bar and other professions.⁹⁹

In summary, the tax generates small amounts of revenue, and its administration is expensive to the government and taxpayers. Thus, the goal of revenue generation provides no substantial basis for the existence of the transfer tax system and yields no background against which to analyze the transfer taxation of closely held businesses.¹⁰⁰

B. Supplementing the Income Tax

The estate and gift tax conceivably supplements the income tax in two ways. First, the estate and gift tax might heighten the progressivity of the income tax rates. Second, the estate and gift tax might remedy certain failures of the income tax system. It is questionable, however, whether the estate and gift tax achieves these goals as effectively as might other measures.

⁹⁶ See McCaffery, *supra* note 4, at 301 (stating that "the actual yield of the[se] taxes is low").

⁹⁷ See *id.* at 301 & n.69 (citing Office of Management & Budget, Budget of the United States Government, Fiscal Year 1992: Historical Tables, tbls. 1.1, 1.3, 2.5 (1991)).

⁹⁸ Donaldson, *supra* note 4, at 548 (footnote omitted).

⁹⁹ See *id.* at 549-50; McCaffery, *supra* note 4, at 302.

¹⁰⁰ Cf. JOHN RAWLS, A THEORY OF JUSTICE 277 (1971) (endorsing transfer taxation "not to raise revenue").

Commentators have asserted that the estate and gift tax operate to buttress the progressive rates of the income tax.¹⁰¹ Professor Michael J. Graetz believes that progressive income tax rates may be self-defeating and that the estate and gift tax is necessary to save progressivity.¹⁰² This observation is true, he finds, because of the following effects. First, higher marginal income tax rates discourage the productivity of affected taxpayers.¹⁰³ Second, high rates encourage affected taxpayers to engage in more legal tax avoidance and illegal tax evasion.¹⁰⁴ Hence, the argument goes, the estate and gift tax is necessary to preserve progressivity.

Professor Donaldson, although not disputing the above arguments, questions them as being dated. Professor Graetz wrote his article, *To Praise the Estate Tax, Not to Bury It*, in 1983. In the article, he called for the reinvigoration of the estate and gift tax following its modification in 1981¹⁰⁵ to restore progressivity to the entire system of taxation.¹⁰⁶ Professor Donaldson, however, observes that the United States Congress has ignored Professor Graetz's call. Professor Donaldson writes,

[A]bsent a congressional resolve to reverse the direction of the 1981 legislation and to expand the scope of transfer taxes by . . . increasing the effective progressivity of the transfer tax rate structure, the existing estate and gift tax system has no meaningful role as a contributor to progressivity. The prospect of such changes is remote and even proponents of the progressivity role of transfer taxation are pessimistic that restoration of such a role is politically possible.¹⁰⁷

¹⁰¹ See Donaldson, *supra* note 4, at 543 (citing Graetz, *supra* note 95, at 271; Gutman, *supra* note 79, at 1185).

¹⁰² See Graetz, *supra* note 95, at 272.

¹⁰³ See *id.* at 273.

¹⁰⁴ See *id.* Professor Graetz also points to certain "preference provisions," such as lower rates on capital gains, which diminish progressivity.

¹⁰⁵ Cf. Donaldson, *supra* note 4, at 544 (citing Alicia H. Munnell, *Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes*, NEW ENG. ECON. REV., Dec. 1988, at 6) (describing how the percentage of taxpayers affected by the estate and gift tax has dropped to 1% following 1981 legislation).

¹⁰⁶ Graetz, *supra* note 95, at 284.

¹⁰⁷ Donaldson, *supra* note 4, at 544 (footnote omitted).

Progressivity in taxation may be a worthwhile goal.¹⁰⁸ Congress, however, is either unwilling to use the estate and gift tax for its promotion, or it has determined that the tax is an ineffective means toward the goal.

The estate and gift tax may supplement the income tax in yet another way. Professor Paul B. Stephan notes that "[o]ne of the principal justifications for a separate tax on the transfer of wealth is that it plugs gaps in the income tax base."¹⁰⁹ The largest gap to which Professor Stephan refers is that "the income tax fails to include substantial portions of capital appreciation"¹¹⁰ in assets that are not sold before their transfer during life or at death.¹¹¹ Under his argument, appreciation enriches the holders of the assets, but they pay no tax on this amount. The absence of a sale or exchange suspends the appreciation in the assets. According to Professor Stephan, the estate and gift tax limits the magnitude of this failure to tax capital appreciation by taxing gratuitous transfers, thereby preventing donors from completely escaping taxation when they transfer property with built in gain.¹¹² Professor Stephan finds further support for this role of the estate and gift tax by analyzing the different transfer tax treatments of gifts and transfers at death. The estate tax has a higher effective rate than does

¹⁰⁸ Cf. Graetz, *supra* note 95, at 274-78; Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 *passim* (1952) (defending the goal of progressivity in taxation).

¹⁰⁹ Paul B. Stephan III, *A Comment on Transfer Tax Reform*, 72 VA. L. REV. 1471, 1472 (1986).

¹¹⁰ *Id.* at 1481.

¹¹¹ The Code generally taxes this appreciation upon the sale of the asset. *See* I.R.C. § 1001(a) (1994). *But cf.* I.R.C. § 1256 (1994) (taxing the increased appreciation of certain investment contracts on a year-to-year basis).

¹¹² Differing marginal rates among family members may create an incentive for donors to make gifts with appreciated property. What if a donor had two pieces of property of equal value, but only one piece has appreciated? If the donor wanted to transfer one as a gift, and if the asset were likely to be sold in the near future, she would be inclined to choose the appreciated piece, because its appreciation would escape taxation in her hands. In most cases the donee, who is a family member, will be in a lower marginal income tax bracket than the donor, which means that a later disposition of the property will likely produce a lower overall income tax burden for the family as a group. A contrary incentive, however, is produced by the step-up in basis at death. *See supra* note 54 and accompanying text. If the property is likely to be sold over the long term, but not in the near term, the donor has an incentive to hold the appreciated property until death, thereby permitting the donee to obtain a new fair market value basis in the property.

the gift tax.¹¹³ Moreover, recipients of testamentary property take a stepped-up basis in the property, whereas recipients of inter vivos gifts do not.¹¹⁴ To summarize, Professor Stephan observes that the income tax fails to tax capital appreciation when transferred either at death or in life. The estate and gift tax responds by separately taxing these transfers. In addition, the income tax prefers transfers at death over gifts by giving only the former an increased basis upon transfer. Again, the estate and gift tax responds by taxing transfers at death at a higher rate than gifts.¹¹⁵

Professor Stephan's pragmatic justification for the estate and gift tax reveals gaps in the income tax, but is not a satisfying justification for transfer taxation. His justification is illusory. Congress could directly solve these gaps, thereby rendering the estate and gift tax superfluous by Professor Stephan's theory. Indeed, the gaps are probably solvable, through one of two alternative approaches.

First, by amending I.R.C. §§ 1014, 1015,¹¹⁶ Congress could equalize the different bases that gifts and testamentary transfers take under current law. As noted earlier,¹¹⁷ under I.R.C. § 1014, most property received from a decedent receives a basis equal to the fair market value of the property at the decedent's death. This provision has long been criticized as a major tax loophole,¹¹⁸ particularly in the absence of an estate tax burden at the decedent's death, as in the case of an estate passing entirely to a surviving spouse.¹¹⁹ As observed by Professor Stephan, however, Congress in 1976, instituted the carryover basis for testamentary transfers, but apparently lacked the commitment for reform because it retroactively repealed the change in 1980.¹²⁰

¹¹³ See *supra* note 50 and accompanying text.

¹¹⁴ See *supra* notes 54-55 and accompanying text.

¹¹⁵ See Stephan, *supra* note 109, at 1482.

¹¹⁶ See *supra* Part II.C. and accompanying text.

¹¹⁷ See *supra* note 54 and accompanying text.

¹¹⁸ See Gutman, *supra* note 79, at 1192 & n.26 (citing various authorities to this effect).

¹¹⁹ See *id.* at 1235-39 (proposing that I.R.C. § 1014 not apply to transfers qualifying for the marital deduction).

¹²⁰ See Stephan, *supra* note 109, at 1485-86.

A second approach would be to treat death as an event that causes the recognition of capital gains. This approach avoids a problem associated with the 1976 carryover-basis legislation—the death tax basis adjustment. With a carryover basis system, it is necessary to increase the basis of appreciated property by the death taxes attributable to the appreciation to make the consequences of carryover basis consistent with the tax results of selling appreciated property before death.¹²¹ As explained by Professor Lawrence Zelenak in a recent article on this subject, in the 1976 legislation the basis adjustment was determined by multiplying the appreciation in each asset by the average death tax rate for the estate.¹²² Although this approach is simple enough in concept, it creates significant practical difficulties because the basis of every appreciated asset in the estate is uncertain as long as the value of any of the assets is uncertain.¹²³ This problem is not encountered if death is a realization event, because all assets would receive a fair market value basis following the imposition of the tax. Moreover, carryover basis would require the maintenance of basis records over multiple generations, while realization at death would not. The realization-at-death approach also has significant revenue advantages.¹²⁴ As Professor Zelenak observes, realization at death imposes the income tax at an ideal time in terms of ability to pay; the decedent has no use for the funds, and whatever the heirs receive is a windfall.¹²⁵

Taxing capital gains at death is also supported by sound tax policy. As observed by Professor Joseph M. Dodge in a recent article responding to Professor Zelenak's argument, imposing capital gains tax at death is supported by at least four different policies: the internal logic of the income tax, economics, fairness, and distributive justice.¹²⁶ By internal logic, Professor Dodge means that, under a sound system of income taxation, "the same dollars should be neither taxed to, nor deducted by, a given taxpayer

¹²¹ See Lawrence Zelenak, *Taxing Gains at Death*, 46 VAND. L. REV. 361, 368 (1993).

¹²² See *id.*

¹²³ See *id.* (observing that this problem exists because the average death tax rate for the estate is a function of the value of every asset).

¹²⁴ See *id.* at 370 (pointing out that the realization-at-death approach would produce more than three times the additional revenue that would be produced by a carryover-basis approach).

¹²⁵ See *id.* at 367.

¹²⁶ Joseph M. Dodge, *Further Thoughts on Realizing Gains and Losses at Death*, 47 VAND. L. REV. 1827, 1838-42 (1994).

more than once."¹²⁷ In no respect is the taxation of gains at death inconsistent with this principle. By economics, Professor Dodge is referring to the concept of economic neutrality—that a sound system of income taxation should minimize its impact on investment decisions.¹²⁸ As Professor Dodge observes, death is an ideal time to impose a tax on capital gains because the tax would affect economic choices only minimally.¹²⁹ As to tax fairness, Professor Dodge argues that taxing gains at death is consistent with the principle that taxpayers should contribute according to their ability to pay.¹³⁰ Regarding the concept of distributive justice, Professor Dodge makes the point that sound tax policy should take into account the relative contributions made to tax revenues by various classes of society.¹³¹ A rule taxing gains at death is consistent with this policy. Moreover, the tax cost is not borne by the transferor, who is dead, but by the transferees for whom the amounts received are, as Professor Dodge observes, "in the nature of a windfall."¹³² Assuming that inherited wealth is less worthy than earned wealth, taxing gains at death furthers vertical equity at a lower tax cost.¹³³

In short, the gaps in the income tax base described by Professor Stephan¹³⁴ can be addressed directly either by instituting a carryover-basis rule or by taxing gains at death. The use of the estate and gift tax as an indirect backstop to these gaps is, therefore, both unnecessary and unsatisfying as a policy matter.

To summarize, commentators have argued that the estate and gift tax supplements the income tax by periodically taxing accumulated wealth and by buttressing the progressive rates of the income tax. The estate and gift tax does not substantially add to the progressivity of the income tax, nor does it need to do so. Congress could easily change the income tax rates. Arguably, the estate and gift tax may strengthen areas where the income tax

¹²⁷ *Id.* at 1839.

¹²⁸ *See id.* at 1840.

¹²⁹ *See id.*; *see also id.* at 1836-37 (arguing that permitting realized appreciation to escape income taxation favors capital appreciation over other types of income).

¹³⁰ *See id.* at 1840-41.

¹³¹ *See Dodge, supra* note 126, at 1841 (observing that this is accomplished, in part, by the progressive rate structure, which produces so-called vertical equity).

¹³² *Id.*

¹³³ *See id.*

¹³⁴ *See supra* notes 109-15 and accompanying text.

is weak by taxing appreciated property when transferred. The necessity, however, of the estate and gift tax as a response to problems in the income tax is dubious. Congress should not indirectly and halfheartedly address these problems under the estate and gift tax. This Subpart shows that the estate and gift tax does little to accomplish income tax related goals; supporting the income tax does not justify the estate and gift tax. As such, the relationship between the income tax and the estate and gift tax does not present a framework by which to analyze the estate and gift taxation of closely held businesses.

C. Reducing the Unfairness of Disparate Accumulations of Wealth

Perhaps the estate and gift tax serves some political goal beyond the production of revenue or the protection of the income tax base. The American Bar Association states, "[t]he transfer taxes serve, among other purposes, to limit the perpetuation of large private concentrations of wealth" ¹³⁵ Yet, why should concentrations of wealth be limited? A possible answer lies in what Professor Edward J. McCaffery calls "the liberal egalitarian case for wealth transfer taxation." ¹³⁶

In a recent article in the *Yale Law Journal*, Professor McCaffery provides an overview of philosophical arguments for limiting wealth accumulation by imposing a wealth transfer tax. Professor McCaffery observes that modern philosophers see the transmission of private wealth as problematic. The transmission of private wealth interferes with the "equality of starting points." ¹³⁷ Hence, wealth transfers interfere with the principle "that people of equal abilities and aptitudes 'should have the same

¹³⁵ American Bar Ass'n Section of Taxation Task Force on Transfer Tax Restructuring, *Report on Transfer Tax Restructuring*, 41 TAX. LAW. 395, 396 (1988); see also McCaffery, *supra* note 4, at 289 (noting that reducing private accumulations of wealth is a purported goal for the estate and gift tax); Joseph M. Dodge, *Redoing the Estate and Gift Taxes Along Easy-to-Value Lines*, 43 TAX L. REV. 241, 249 ("It is sometimes said that a wealth transfer tax curbs undue accumulations of wealth.").

¹³⁶ McCaffery, *supra* note 4, at 289 (lower case added).

¹³⁷ *Id.* at 290 (citing BRUCE A. ACKERMAN, *SOCIAL JUSTICE IN THE LIBERAL STATE* 202-27 (1980)).

prospects of success regardless of their initial place in the social system, that is, irrespective of the income class into which they are born.'"¹³⁸

Professor McCaffery criticizes this argument on practical and philosophical grounds. First, he argues that the current estate and gift tax "encourages frequent, large, *inter vivos* gifts,"¹³⁹ and that no stronger alternative to this system is politically feasible.¹⁴⁰ Second, he believes that a stronger alternative would encourage the wealthy to consume, rather than transfer, their wealth, thereby substituting inequality of consumption for inequality of wealth.¹⁴¹ Moreover, an estate and gift tax runs counter to the liberal ideal that possession of earned wealth is just. People hold this wealth as capital, which supports the material needs of society. Indeed, the estate and gift tax encourages consumption, and thus the dissipation, of this wealth.¹⁴²

Hence, egalitarian philosophical arguments do not satisfactorily justify the estate and gift tax.¹⁴³ The liberal ideal of equality of starting points conflicts with the liberal ideals of saving and thrift, thereby leaving the estate and gift tax in a philosophical limbo. This egalitarian justification fails, providing no model in which to analyze the transfer taxation of interests in closely held businesses.

D. An Economic Justification of the Estate and Gift Tax

The estate and gift tax decreases gratuitously transferred wealth. Perhaps by doing so the tax encourages the productive work effort of potential recipients. More than one hundred years ago, Andrew Carnegie wrote,

¹³⁸ *Id.* at 292 (quoting Rawls, *supra* note 100, at 73).

¹³⁹ McCaffery, *supra* note 4, at 294; *cf. supra* note 41 and accompanying text (describing the \$10,000 per donee annual exclusion from gift tax).

¹⁴⁰ *See* McCaffery, *supra* note 4, at 294.

¹⁴¹ *See id.* at 295.

¹⁴² *See id.* at 295-96.

¹⁴³ Professor McCaffery advocates abolition of the income tax and the estate and gift tax. In their place, he would institute a "progressive consumption-without-estate tax." *Id.* at 296, 345-58.

I have therefore endeavored to prove that at the root of the desire to bequeath to children there lay the vanity of the parents, rather than a wise regard for the good of the children. That the parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and less worthy life than he otherwise would, seems to me capable of proof which cannot be gainsaid. It is many years since I wrote in a rich lady's album, "I should as soon leave to my son a curse as the almighty dollar."¹⁴⁴

This Article argues that reducing the heir's temptation to "lead a less useful and less worthy life"¹⁴⁵ is a worthwhile goal of the estate and gift tax.

1. Microeconomic Analysis of Inheritance and Recipients' Work Efforts

The argument that inheritance reduces the incentive for recipients to work productively has popular appeal beyond Carnegie's conjecture. Lotteries are an appropriate analogy to inheritance and to large inter vivos gifts. Both involve individuals who receive wealth by chance, that is, by choosing the right numbers or having affluent relatives. Popular tales abound of how individuals win a lottery, retiring from their jobs to lead a life of relaxation, if not luxury.¹⁴⁶ The media also contain stories of how

¹⁴⁴ Andrew Carnegie, *The Advantages of Poverty*, in *THE GOSPEL OF WEALTH AND OTHER TIMELY ESSAYS*, 43, 49-50 (1933).

¹⁴⁵ *Id.*

¹⁴⁶ See, e.g., Shannon Tanganan, *A \$101.8M Ticket to Retirement—Phoenix Couple Hit the Jackpot*, U.S.A. TODAY, March 7, 1995, at 3A (describing how one couple went into retirement overnight after winning the lottery).

recipients of large inheritances withdraw from productive activities¹⁴⁷ or never engage in them at all because of large inheritances.¹⁴⁸

The idea that recipients of large inheritances withdraw from productive work is intuitively appealing, and this intuition finds a theoretic justification in microeconomic analysis. Individuals work, for the most part, to buy goods and services from the larger economy. The worker receives pay and uses it to buy these goods and services. Another tenet of microeconomics is that more goods and services are better than fewer.¹⁴⁹ Under this analysis, workers would constantly work to maximize their ability to purchase the desired goods and services.

This conclusion is, of course, absurd. The analysis is not flawed, but it is incomplete. One specific economic good is leisure (or the absence of work), and its value prevents individuals from constantly working. As one text states, "[t]he decision to work is ultimately a decision about how to spend time."¹⁵⁰ Presumably, workers want leisure just as they want the goods and services previously discussed. Workers do not buy leisure in the traditional sense, but acquiring it is not without cost. Leisure has an opportunity cost—an hour of leisure costs the worker an hour of pay.¹⁵¹

The value an individual places on leisure, compared with the value placed on other goods and services, determines the individual's work effort.¹⁵² An individual participates in work, or any other activity, at a level

¹⁴⁷ By "productive" we mean work or activities that return wealth or the expectancy of wealth as a direct result of the work or activity. Hence, philanthropic activities would not come within our discussion, because society at large would receive the tangible return (other than the philanthropist's personal satisfaction). We do not mean to say that philanthropy is not productive, but that it is distinct from what most people would call work.

¹⁴⁸ See, e.g., Eric Morganthaler, *Oh Lucky Man: His Life is a Cruise, Year in, Year Out*, WALL ST. J., Dec. 20, 1991 at A1 (describing how one heir to a multimillion dollar estate has never worked and spends much of his time taking cruises).

¹⁴⁹ See EDWIN MANSFIELD, MICROECONOMICS 50 (1991) (assuming "the consumer always prefers more of a commodity than less").

¹⁵⁰ ROBERT G. EHRENBURG & ROBERT S. SMITH, MODERN LABOR ECONOMICS 179 (1991).

¹⁵¹ See *id.* at 180 (assuming that "leisure's opportunity cost is the wage rate") (emphasis deleted).

¹⁵² See *id.* at 153-54. Economists analyze the work decision by dividing goods into two categories: leisure and money income.

such that the marginal utility of the gain from the activity equals its marginal cost.¹⁵³ This is a central holding of modern microeconomics.¹⁵⁴ The marginal gain from a unit of work is the accompanying increase in wealth that allows the worker to purchase extra goods and services. The marginal cost is the foregone leisure that the worker would have enjoyed without the extra work effort. Hence, the worker balances the value of work (*i.e.*, the wealth that it produces) and the value of leisure in determining his or her individual level of work.¹⁵⁵

How does increased wealth affect this balance? Economic theory supports the notion that increased wealth causes people to work less. Typically, economists expect that increases in wealth or income cause people to consume more of the goods they want. These goods are normal goods.¹⁵⁶ Conversely, consumers consume less of other goods when wealth increases. These goods are inferior goods.¹⁵⁷

Economists consider inferior goods to be atypical. Examples of inferior goods usually include inexpensive substitutes for other goods.¹⁵⁸ Leisure hardly fits within this description because it has few, if any, substitutes. Economists typically assume that leisure is a normal good,¹⁵⁹

¹⁵³ Economists analyze this situation by looking at consumers' budget constraints and their preferences for combinations of goods. *See id.* at 156-59. The budget constraint represents the worker's ability to consume leisure versus other goods. The preferences represent the worker's willingness to substitute one good for another (*e.g.*, the value of an extra unit of leisure versus the value inherent in an extra hour of wages). At the optimal work level for the consumer, the ability to exchange leisure for other goods corresponds to the willingness to do so. A leading microeconomics text states:

The rate at which the consumer is willing to substitute good X for good Y (holding satisfaction constant) must equal the rate at which he or she is able to substitute good X for good Y. Otherwise it is always possible to find another market basket that will increase the consumer's satisfaction.

MANSFIELD, *supra* note 149, at 79.

¹⁵⁴ *Cf.* EDWIN MANSFIELD, MICROECONOMICS 50 (1991) ("This is a famous result—and a very useful one that should be understood fully.")

¹⁵⁵ *See supra* note 153 (examining this balance of work and leisure time).

¹⁵⁶ *See* MANSFIELD, *supra* note 154, at 89.

¹⁵⁷ *See id.*

¹⁵⁸ *Cf.* EHRENBURG & SMITH, *supra* note 150, at 179 (describing public transportation as an inferior good); MANSFIELD, *supra* note 154, at 90 (describing oleomargarine as an inferior good).

¹⁵⁹ *See* Douglas Holtz-Eakin & David Joulfaian, *The Carnegie Conjecture: Some Empirical Evidence*, 108 Q.J. ECON. 413, 414 (1993).

although the empirical evidence as to the normalcy of leisure has been ambiguous.¹⁶⁰

If leisure is a normal good, then increases in wealth are accompanied by decreases in work effort. That is, wealthier workers consume more leisure by decreasing their work effort. Inheritance is a pure increase in wealth that is not associated with any work effort.¹⁶¹ Thus, economic theory supports the notion that inheritance decreases the recipient's work effort.

To summarize, leisure is an economic good. Its cost is the foregone wages that the worker did not earn while consuming leisure. Workers determine their work effort by balancing their desire for more wealth with their desire for more leisure. Inheritance affects this balance because it gives the recipient the means to consume more leisure by working less. Leisure is probably a normal good because people will consume more of it given an increase in their wealth. Hence, under this microeconomic analysis, inheritance provides a disincentive to work.

¹⁶⁰ See *id.* (citing John Pencavel, *Labor Supply of Men: A Survey*, in HANDBOOK OF LABOR ECONOMICS 63-64 (1986)). But see *infra* Part III.D.2. (finding labor participation to decline with large inheritance).

¹⁶¹ By "pure" we mean that inheritance does not result from higher wages. Thus, it does not increase the marginal cost of leisure. A wage increase is an impure increase in wealth from this viewpoint. A wage increase certainly makes the worker wealthier if the worker continues with the same work effort. The wage increase also increases the marginal cost of leisure, which is the hourly wage itself. This effect makes leisure more expensive. If leisure is a normal good, an increase in the hourly wage pulls the worker in two directions. First, the increased wealth draws the worker to consuming more leisure. Second, the higher wage draws the worker to consuming less leisure because it is now more expensive. Essentially, the increased wage gives the worker the means to consume more leisure, but also makes it more expensive. See MANSFIELD, *supra* note 159, at 89-90.

Leisure, as an economic good, has an interesting feature in this context. Ordinarily, when the price of a good (*e.g.*, bread) goes up, the consumer is poorer because available income will now buy less of the good. If that good is a normal good, then the consumer will necessarily consume less of it; the decreased wealth and the increased price relative to other goods will convince the consumer to consume less of it. In contrast, the price of leisure is the wage rate. If the price of leisure (*i.e.*, wages) increases, then the consumer of leisure becomes wealthier. Thus, if leisure is a normal good, it is ambiguous whether the consumer chooses to work more or less after a wage increase.

2. *Empirical Evidence of the Effect of Inheritance on Work Efforts*

In a recent article, *The Carnegie Conjecture: Some Empirical Evidence*,¹⁶² three researchers set out to learn whether inheritance affects labor market participation. Labor participation is a binary decision. Under the researchers' model, an individual participated in the labor market if the individual had any earnings from wages, salary, or a sole proprietorship.¹⁶³ Participation is distinct from supply. Whereas labor participation is a yes-no decision, supply reflects the number of hours worked. Supply is difficult to measure because of the lack of statistics for hours worked.¹⁶⁴

The researchers analyzed estate tax returns of decedents who died in 1982. The decedents' estates filed the returns in 1982 or 1983. The researchers matched these estate tax returns with the 1982 and 1985 income tax returns of the beneficiaries.¹⁶⁵ The estate tax returns identified the amount of individual inheritances and the beneficiaries. The income tax returns provided information on the recipients' work efforts before and after receiving their inheritances. Specifically, the researchers considered a recipient of an inheritance to be a participant in the labor market if the participant had any wage, salary, or sole proprietorship earnings.¹⁶⁶

The researchers also obtained information on the labor participation of joint filers. At the time of the study, the Code and the relevant income tax return contained information allowing the researchers to determine whether one, both, or neither of the spouses participated in the labor market.¹⁶⁷

¹⁶² Holtz-Eakin & Joulfaian, *supra* note 159.

¹⁶³ *See id.* at 416.

¹⁶⁴ *See id.* at 417.

¹⁶⁵ *See id.* at 416.

¹⁶⁶ *See id.* at 417.

¹⁶⁷ *See Holtz-Eakin & Joulfaian, supra* note 159. The specific information relates to a deduction based upon the earnings of the lower-earning spouse. The deduction was a percentage of these earnings. Hence, if the joint return reported no active income, then neither spouse participated in the labor market. If the joint return reported active income, but no special deduction, then only one spouse participated in the labor market. Finally, if the joint return reported active income and the special deduction, then both spouses participated in the labor market. The researchers obtained this information for both 1982 and 1985.

The researchers used the income tax returns to examine the effect of the individuals' inheritances upon their respective transitions into and out of the labor force between 1982 and 1985.¹⁶⁸ Thus, the researchers could compare the beneficiaries' labor force participation with the size of their inheritances.

The researchers used the tax data to construct tables showing transitions into and out of the labor market. Using these tables, the researchers first observed the effects of inheritances on single filers. They concluded that Andrew Carnegie was in fact correct:¹⁶⁹ "higher inheritances are associated with a greater propensity to exit the market."¹⁷⁰ The most dramatic results occurred with inheritances of more than \$150,000. Of individuals filing a single return with such inheritances, approximately 18% of those already in the labor market left it within three years of receiving the inheritance.¹⁷¹ The researchers also noted that inheritance deters reentry to the labor market.¹⁷² For example, of those not in the labor market in 1982, only 16% of those who inherited more than \$150,000 had entered by 1985.¹⁷³

The researchers also constructed tables demonstrating the effects of inheritances on joint filers. These results were even more dramatic than those for single filers, and the most meaningful transition was from two earners to one earner. If both husband and wife were in the labor market before receiving an inheritance of over \$150,000, approximately 34% of the time one or both of them left it within three years.¹⁷⁴

The researchers tested these results by using multi-variate analysis that isolated the effect of increasing age on leaving the work force. They found that the effect of inheritance was still significant.¹⁷⁵

¹⁶⁸ See *id.* at 415.

¹⁶⁹ See *id.* at 420.

¹⁷⁰ See *id.*

¹⁷¹ See *id.* at 418.

¹⁷² See *id.* at 422 (noting that not all of these results were statistically significant).

¹⁷³ See *id.* at 420.

¹⁷⁴ See *id.* at 420-21. Of those cases where joint-filers received inheritances over \$150,000, both spouses worked in 259 instances in 1982. In 1985, both spouses left the work place 7 times (2.7%) and one spouse left 80 times (30.9%). This leads to a total of 33.59% when at least one spouse left (derived by $(80 + 7)/259 = 0.3359$).

¹⁷⁵ See *id.* at 424-26.

In a more recent article, two researchers investigated the relationship between inheritance and labor supply.¹⁷⁶ Labor supply and participation, as stated before, are distinct. Workers may work fewer hours or at an easier job for less pay. If so, they reduce their labor supply, but still participate in the labor force. These researchers found that "the labor disincentive of inheritance is fairly small."¹⁷⁷ For the largest estates, however, the researchers excluded from consideration those who left the labor force after receiving the inheritance.¹⁷⁸ Hence, the researchers of labor supply ignored the very subjects whom the earlier researchers found most interesting: those who left the labor market.¹⁷⁹ This approach may seem curious because it excludes the biggest changes from the study. The value of this approach, however, lies in its ability to explain workers' reactions to inheritance at the margin. The earlier research provided clear support that inheritance lures people out of the labor market. The later research provides equally clear support that those who resist the lure, by and large, resist it completely. Hence, the articles provide a general observation: recipients of a large inheritance are less likely to work at all. If beneficiaries do work, however, their work habits are not substantially different from before.¹⁸⁰

Empirical evidence not only establishes that Andrew Carnegie was correct about the effect of inheritances on donees, but also supports an economic justification for the estate and gift tax. By imposing a tax on

¹⁷⁶ David Joulfaian & Mark O. Wilhelm, *Inheritance and Labor Supply*, 29 J. HUM. RESOURCES 1205 (1994). David Joulfaian was also one of the three writers of *The Carnegie Conjecture: Some Empirical Evidence*. See Holtz-Eakin & Joulfaian, *supra* note 159.

¹⁷⁷ See Joulfaian & Wilhelm, *supra* note 176, at 1207; see also Holtz-Eakin & Joulfaian, *supra* note 159, at 430-32 (finding that effect on supply is less pronounced when keeping participation constant).

¹⁷⁸ See Joulfaian & Wilhelm, *supra* note 176, at 1225 ("However, when person-years with very large changes in earnings are excluded . . . the estimate falls to [low levels of disincentive].").

¹⁷⁹ Cf. *id.* at 1231 ("Indeed, excluding outliers in earnings changes in our models necessarily removes the observations containing exits from the labor market.") (footnote omitted).

¹⁸⁰ This observation is analogous to even earlier research on the effect of wage rates on primary and secondary earners in a family. This research found that the work effort (*i.e.*, labor supply) of the secondary worker varies directly with the wage rate; however, the work effort of the primary earner is independent of the wage rate. See John Pencavel, *Labor Supply of Men: A Survey*, in 1 HANDBOOK OF LABOR ECONOMICS 204 (1986); MARK KILLINGSWORTH, LABOR SUPPLY 94 (1983).

gratuitous transfers, the estate and gift tax prevents beneficiaries of gratuitously transferred property from failing to contribute their skills and efforts economically. Moreover, the estate and gift tax encourages regular lifetime donations of modest amounts rather than lump-sum inheritances.

In sum, empirical research establishes that the receipt of modest inheritances affected labor-force participation less than larger ones.¹⁸¹ Additional research establishes that, absent effects on participation, inheritance minimally affects labor supply.¹⁸² Thus, by reducing large estates and forcing donors to give smaller, regular amounts during life, the estate and gift tax coerces donors to convert inheritances into a stream of lifetime gifts that do not disrupt labor participation.

3. *A Work-Based Policy of the Estate and Gift Tax*

Parts III.D.1 and 2 of this Article show that microeconomic theory and empirical research associate inheritance with lower worker effort. Moreover, the empirical research shows that the only statistically significant effect of inheritance is that heirs receiving large inheritances are more likely to leave the labor force. In contrast, when heirs continue to work their level of participation (measured by annual earnings) remains constant.¹⁸³ Thus, recipients of inherited wealth usually have a binary decision-making process. They will either leave work or stay. They will not, as a general rule, significantly decrease their work effort if they stay.

Curiously, the estate and gift tax provides a relatively tailored remedy to this phenomenon.¹⁸⁴ First, the current system taxes only relatively large estates.¹⁸⁵ Second, the current system encourages wealthy individuals to

¹⁸¹ Holtz-Eakin & Joulfaian, *supra* note 159, at 418. For example, only 4.57% of single return filers who received inheritances of less than \$25,000 left the labor market within three years. Perhaps similar results would hold for recipients of planned giving who receive \$10,000 in annual gifts from a parent or \$20,000 a year from both parents together. However, these researchers did not study the effects of gifts on labor force participation.

¹⁸² See *supra* notes 176-80 and accompanying text.

¹⁸³ See *supra* Part III.D.2.

¹⁸⁴ We do not argue (or believe) that Congress ever considered this effect of the estate and gift tax.

¹⁸⁵ See *supra* note 4 (discussing the wealthiest taxpayers who pay the tax).

transfer their wealth in an inter vivos stream of smaller gifts, rather than by a lump-sum at death.¹⁸⁶

These two results diminish the harmful effects of gratuitous wealth on work effort. First, by reducing the largest estates, the system diminishes the likelihood that heirs will quit work; larger inheritances influence recipients more than smaller inheritances. Second, by converting large estates into a stream of lifetime gifts, the transfer of wealth is less likely to disrupt work effort. If the wealth is not enough to cause the recipient to leave the work force, its effect is not significant. Therefore, the estate and gift tax is a suitable response to the problem of heirs leaving the work force.

Public policy, through the estate and gift tax, should, as a normative matter, address the work efforts of heirs. Economically, attrition by heirs imposes real economic costs on society that may frustrate macroeconomic policy. Philosophically, encouraging the recipients of wealth to work ameliorates the injustice of unequal wealth.

Individuals are prone to leave the work force when they inherit wealth. This phenomenon indicates that heirs do not foresee or rely upon their inheritance. If they did, they probably would have never worked at all or engaged in lower levels of work that they would continue after inheriting wealth.¹⁸⁷ Hence, future heirs may systematically fail to estimate the size or timing of their inheritance.

This failure may cause future heirs to overinvest in human capital. If they knew they would leave the workforce, then their investments in human capital would decrease accordingly (as would their employers'). Investments in human capital are costly to the worker and society.¹⁸⁸

When heirs leave the work force, their employers must find replacements. If the heirs were highly skilled, the search is even more extensive

¹⁸⁶ See *supra* Part III.D.2.

¹⁸⁷ This observation is a corollary to the life-cycle model of labor supply. The life-cycle model implies that people work the most during the stages in their lives when they are most productive. Early in life, they spend their time investing in human capital. In the middle they work. In the end, they stop working for various reasons. See generally Ehrenberg & Smith, *supra* note 150, at 242-53.

¹⁸⁸ See *id.* at 301 (describing the costs of investments in human capital).

and costly. These activities cause real social costs.¹⁸⁹ Encouraging beneficiaries to work reduces these costs.

Full economic productivity and full employment are important macroeconomic goals. Workers leaving the work force endanger these goals. By encouraging work force participation from heirs, the estate and gift tax augments the macroeconomic goals of full productivity and full employment.

Previously, this Article discussed the failure of the estate and gift tax to achieve egalitarian justice.¹⁹⁰ Specifically, the current system does not decrease inherited wealth to achieve true equality in starting points for members of society. Furthermore, any stronger alternative may endanger capital production or encourage ostentatious consumption by the producers of wealth.

Although the current system may not substantially decrease wealth, it may have an effect on the work efforts of recipients. By encouraging heirs to work, the current system makes inequality more palatable.¹⁹¹ The inequity remains because the rich stay rich. However, the inequity is not so large because the rich stay in the work force.

Indeed, work may be virtuous in itself. Andrew Carnegie described inheritance as a curse because the heir might never have the chance to find her own way.¹⁹² Presumably, Carnegie meant that the heir did not know any better than to leave the work force, where one finds the moral value of productive work. The estate and gift tax may act in a paternalistic manner to save the heirs from themselves so that they find virtue in work.

In summary, the estate and gift tax plays a rational role in encouraging work by recipients of gratuitous wealth.¹⁹³ Indeed, aspects of the estate and gift tax are seemingly tailored to this task. Furthermore, encouraging

¹⁸⁹ EHRENBERG & SMITH, *supra* note 150 at 166 ("firms incur significant costs in hiring employees").

¹⁹⁰ See *supra* Part III.C.

¹⁹¹ Cf. RAWLS, *supra* note 100, at 73 (distinguishing between a frugal capitalist class and an indulgent aristocracy).

¹⁹² Carnegie, *supra* note 144, at 50.

¹⁹³ See *supra* Part III.D.3.

work effort by heirs is a sensible policy. Economically, attrition from work creates social costs and disrupts macroeconomic policy. Philosophically, encouraging work decreases the inequity of disparate wealth and leads heirs into finding the virtue of productive work.

4. Summary

Andrew Carnegie's intuition and modern economic research point to one achievable goal for transfer taxation—encouraging recipients of donated wealth to engage in productive work. The empirical research establishes that recipients of large inheritances are much more likely to exit the labor force than are other workers. Yet, those who do stay in the labor force are not particularly prone to decrease their supply of labor. Hence, only relatively large inheritances affect labor supply by prompting some workers to exit. The federal estate and gift tax remedies this problem in two ways. First, it decreases large inheritances by taxing them—decreased inheritances create less disruption in the labor market. Second, it coerces donors to transfer their wealth in smaller, lifetime gifts rather than by larger inheritances. Smaller gifts do not disrupt the labor market as do larger inheritances. Government has a proper role in encouraging heirs to work. Doing so reduces social costs and promotes social justice. This justification is the model that the next section of this Article uses to explore the proper transfer taxation of interests in closely held businesses.

IV. CLOSELY HELD BUSINESSES UNDER THE ESTATE AND GIFT TAX

Part II of this Article reviewed the estate and gift tax provisions and the specifics of their application to closely held businesses. Part III justified and explained this regime by examining the effects of inheritance on labor participation. This Part examines the gratuitous transfer of closely held businesses under that justification. The argument that the estate and gift tax encourages productive work by donees does not apply in one context. If the taxed transfer is of a business in which the donee will participate, the estate and gift taxes do not further this goal. In this situation, the donee is already engaged in productive work and does not need the Code for persuasion into

productivity. Thus, Congress should reconsider the taxation of the transfer of interests in closely held businesses.

Interests in closely held businesses are analytically distinct from other property. The recipient of securities, real estate, and cash may not work to maintain the assets. Most income from these assets is passive income. The holder of a large interest in a closely held business may, however, undertake actively to manage or participate in the business. Thus, these interests are inherently distinct from other forms of donated wealth.

Part III.D described how beneficiaries of inheritances may decrease their labor force participation. The estate and gift tax ameliorates this problem by taxing larger estates. It also provides an incentive for donors to make lifetime gifts of property rather than giving all of their property in a lump sum at death. Nevertheless, this policy may not be relevant when the recipient of an interest in a closely held business intends to participate actively in its management. Here, the recipient already intends to meet the policy without encouragement by the Code.

Beyond consumption, another reason for accumulating wealth exists. Many individuals enjoy giving some of their wealth to the natural objects of their bounty. The estate and gift tax, of course, curtails these gratuitous transfers. Hence, the tax is effectively a tax on capital because it reduces the attractiveness of capital to individuals.¹⁹⁴

Presumably, individuals work to gain wealth. Wealth, of course, allows individuals to consume goods and services. But, people also produce wealth to pass to their children and other beneficiaries.¹⁹⁵ The ability to

¹⁹⁴ See Richard Wagner, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION, in *FEDERAL TRANSFER TAXATION: A STUDY IN SOCIAL COST*, at 17-19 (1993) (arguing that, empirically, the federal estate tax has, and will continue to, depress the capital supply of the United States).

¹⁹⁵ That is, people want wealth not only for direct consumption, but also for donative purposes. Commentators continue to debate why people like giving away their wealth. The altruistic camp argues that giving away wealth confers direct enjoyment upon the donor. The services camp believes that people use gifts to family for control; that is, they extract services from family members (such as attentiveness and visits) in exchange for gifts and the promise of a pay-off at death. See B. Douglas Bernheim et al., *The Strategic Bequest Motive*, 93 J. POL. ECON. 1045 (1983).

Of course, it is possible that people obtain wealth for wealth's sake and give it to

consume and give away wealth makes greater wealth desirable. The estate and gift tax reduce the ability of individuals to enjoy their wealth fully because it limits gratuitous transfers.¹⁹⁶ The two effects of this limitation are fairly obvious. First, people will work less because the reward (wealth) is cheapened by the estate and gift tax.¹⁹⁷ Second, people will consume more and save less because the latter use is relatively more expensive than the former.¹⁹⁸ Both of these effects diminish society's supply of capital. The first retards its original formation, while the second accelerates its dissipation. Thus, the estate and gift tax harmfully affects productive capital accumulations.

Previously, this Article found justification for the estate and gift tax in its effect on recipients of wealth.¹⁹⁹ The estate and gift tax encourages productive work from potential recipients of inherited wealth in two ways. First, it discourages gratuitous transfers in general. Second, it encourages donors to structure their transfers into a stream of small, inter vivos gifts, which is less disruptive on labor supply than large, lump-sum inheritances.

We assume, for the sake of argument, that the benefits of the estate and gift tax outweigh the costs. Americans gain from the tax by its encouragement of productive work by donees and to a lesser extent from its revenues. Americans lose from the tax by its discouragement of capital production. These are the stakes, and we assume that they favor retaining the basics of the current system. Nonetheless, when applied to closely held

their children for want of a better use at death. See Ascher, *supra* note 15, at 100-01 (hypothesizing that people accumulate wealth for its own sake). A corollary to this theory is that people do not have a strong desire to leave wealth to their children. Our experiences cause us to question this argument, but we admit that it is an empirical question that we are not equipped to answer.

¹⁹⁶ Transfer taxation certainly does not prevent the passage of wealth, but it does coerce people into giving it away in awkward ways. Compare *supra* note 4 (arguing that transfer taxes do not stop the passage of wealth) with *supra* notes 139-42 and accompanying text (arguing that transfer taxes encourage people to give their wealth in a stream of lifetime gifts, rather than all at death).

¹⁹⁷ See Ascher, *supra* note 15, at 101-02.

¹⁹⁸ See *supra* text accompanying notes 141-42 (arguing that the estate and gift tax creates inequality of consumption).

¹⁹⁹ See *supra* Part III.D.

businesses, the tax has no benefits, but still has costs. Hence, the estate and gift tax should have a different application to closely held businesses.²⁰⁰

The application of the tax should be different when it does not beneficially affect donees' work decisions. The primary benefit of estate and gift taxation evaporates when it taxes the transfer of interests in closely held businesses in which the recipients will participate. Estate and gift taxation benefits society by encouraging productive work on the part of recipients. If a recipient receives an interest in a closely held business and intends to manage the business, then no benefit exists for taxing the transfer of the business.

The estate and gift tax has potentially adverse economic effects; its application to the transfer of interests in closely held businesses is not even neutral. The estate and gift tax indirectly levies a tax on capital. Part of the value of capital is the owner's ability to leave it to family and other loved ones. This cost is present in the taxation of closely held businesses, even though the benefits disappear.

The special estate and gift tax provisions already in the Code do not properly address the problem of taxing the transfer of interests in closely held businesses.²⁰¹ The special use valuation rule of I.R.C. § 2032A simply allows certain recipients of interests in closely held businesses to escape what would otherwise be the unfair taxation of their interests based on highest and best use. When I.R.C. § 2032A applies, the business has a reduced going concern value, though the underlying property may be economically more valuable in another use.²⁰² I.R.C. § 6166 provides relief from the illiquidity of closely held businesses when the recipients must pay estate tax. I.R.C. § 303 allows the owner of a closely held corporation to pay the estate tax attributable to the corporation with corporate assets without recognizing ordinary income.²⁰³ Thus, none of these provisions

²⁰⁰ We believe the question of whether the benefits outweigh the costs of the estate and gift tax is an empirical one, and outside the scope of this Article. Nonetheless, our analysis indicates that any benefits disappear in the context of closely held businesses.

²⁰¹ Cf. *supra* Part II.D. (describing the special estate tax provisions applicable to closely held businesses).

²⁰² See *id.*

²⁰³ See *id.*

provides the appropriate dispensation to recipients of closely held businesses from wealth transfer taxation.

Current transfer taxation of closely held businesses retains all of the costs of the larger system, but none of the benefits. Moreover, the special provisions in the Code related to closely held businesses do not solve this dilemma because they do not address its central issue: interests in closely held businesses are distinct from other wealth.

Congress should thus provide legislation that goes beyond the current treatment of interests in closely held businesses.²⁰⁴ Of course, any revisions of the Code should allow special treatment of closely held businesses only where the recipients of the interests plan actively to manage the business.²⁰⁵ Moreover, special treatment should apply to transfers under the estate and gift tax, whereas currently the special provisions for closely held businesses apply only to the estate tax.²⁰⁶ Preventing abuse by taxpayers may be difficult.²⁰⁷ But, helping the transfer of closely held businesses and promoting the growth of productive capital are worth the effort.

To summarize, Part III of this Article establishes that the estate and gift tax beneficially discourages recipients of gratuitous wealth from decreasing their work effort. This Part, however, applies the general justification for the estate and gift tax to a specific issue—the proper transfer taxation of interests in closely held businesses. This Part concludes that if

²⁰⁴ Cf. AMERICAN FAMILY TAX RELIEF ACT, *supra* note 80 (exempting a portion of qualified interests in closely held businesses from decedents' estates).

²⁰⁵ Cf. I.R.C. § 2032A (1994) (allowing a special use valuation for real estate that is part of a farm or closely held business where the recipient materially participates in the operation of the farm or business).

²⁰⁶ Cf. Letter from L. Henry Gissel, Jr., President, *The American College of Trust and Estate Counsel*, to Representative Bill Archer, Chair, *Committee on Ways & Means, United States House of Representatives* (November 10, 1995), reprinted in 21 ACTEC NOTES 261 (1995).

²⁰⁷ For example, an individual may own a closely held business and other wealth. If the Code provides a lower rate or other preferential treatment to the transfer of the closely held business, the individual will find it advantageous for the business to hold some of the other wealth. Because the individual's estate probably could offer a plausible business purpose for some such techniques (*e.g.*, the individual arguably transferred securities to the business to allow the business to meet cash flow needs), interests in closely held businesses probably should not be completely exempt from transfer taxation.

the recipients of interests in closely held businesses intend to actively manage this business, then taxing the transfer of these interests does not further the general goal of transfer taxation.

V. CONCLUSION

This Article began by providing an overview of the law of estate and gift taxation and then established a workable, economic theory for its imposition. The estate and gift tax is necessary to give donees the proper incentives to work. This policy is not valid, however, if the transferred wealth is an interest in a closely held business in which the donee will actively participate. In this situation, the estate and gift tax is detrimental. It interferes with the transferor's decision to accumulate or consume this wealth without the offsetting benefit of encouraging the donee to work. Thus, Congress should reconsider applying the estate and gift tax to closely held businesses.