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A SURVEY OF GENERATION-SKIPPING TRANSFERS — THE PRESENT RULE AND THE POSSIBILITY OF REFORM

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A grantor may avoid federal estate and gift taxes in one or more generations by disposing of his property in a generation-skipping transfer.[1] For example, if a father gave property to his son for life with a remainder to his grandchildren, a taxable transfer would not occur at the death of the son because present law does not consider the termination of the son's life estate as a transfer of property.[2] Therefore, after the grantor pays the gift tax on the transfer, the federal estate and gift taxes are avoided until the grandchild transfers the property. By the use of a trust, special powers of appointment and limited rights to invade the corpus, the grantor may leave the intermediate beneficiary, his son, in virtually complete control of the property and at the same time avoid federal estate and gift taxes upon the son's death. Since generation-skipping transfers deprive the intermediate beneficiary of complete control over the property, they can be used only when the testator decides that the tax advantage to be obtained outweighs the disadvantage to the intermediate generation.

A Definition of Generation Skipping. A generation-skipping transfer is the gratuitous transfer of property so that the fee interest may vest only in individuals two or more generations younger than the grantor. Usually persons one or more generations younger than the grantor will have an intervening limited interest which will terminate upon the passage of time or the occurrence of some other event.[3] Transfers that receive the tax benefits of generation skipping may be in various forms. An outright gift by a grandfather to his grandchildren would avoid the estate tax in one generation, but the intermediate generation would receive no benefit. Other methods may be used to avoid estate taxes in one generation and still allow the intermediate generation to enjoy some benefits from the property. The grant of a life estate by a father to his son with the remainder to the grandchildren is one of the more common types. A person also may give or devise the property for a term of years to the intermediate generation with the remainder to the testator's grandchildren. Greater flexibility may be obtained by making the transfer in trust. The beneficiary's interest may be a definite income interest or may be in the discretion of the trustee. Furthermore, the intermediate beneficiaries may be given the power to dispose of the corpus by the use of special powers of appointment and by the use of limited powers to invade the corpus for their benefit.

Generation-skipping transfers may also be made to collateral relatives or persons who are not relatives. Generally in these cases the relative ages

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[1] G. JANTSCHER, TRUSTS AND ESTATE TAXATION 3 (1967) [hereinafter cited as JANTSCHER]; C. SHOUP, ESTATE AND GIFT TAXES 51 (1966) [hereinafter cited as SHOUP].

[2] 2 J. MERTENS, THE LAW OF FEDERAL GIFT AND ESTATE TAXATION § 20.10 (1959) [hereinafter cited as MERTENS].

[3] SHOUP 33-36.

of the grantor and the holder of the limited interest must be examined to determine if any taxes have been avoided. For example, if a nephew and uncle were the same age, and the uncle gave the nephew a limited interest, an examination of the time sequence involved would show that no generations were actually skipped. In general, when a person gives an individual who is not a direct descending relative a limited interest, generation skipping occurs if the donee is of such an age that he could be the donor's son or daughter. Thirty years[4] is commonly used as the time span between the ages of the donor and donee which determines if a generation has been skipped.

As long as the beneficiaries are direct descendants of the donor, the definitional problems are greatly reduced. However, when the beneficiaries are collaterals or non-relatives, the definition of generation skipping becomes more difficult, and proper definition becomes extremely important when legislation is considered to prevent the use of generation-skipping transfers for tax avoidance. Since this constitutes one of the most obvious and widely used loopholes in the present federal gift and estate tax system,[5] those concerned with tax policy have searched for a way to prevent its use. Though several proposals have been made, none has been adopted.

I. THE SUBSTANTIVE LAW

The heart of generation-skipping tax law involves the basic rule that estate taxes are due only upon property owned by the decedent and subject to transfer at his death. Since life estates or other limited interests terminate upon death, there is nothing to transfer after the holder's death and no portion of the interest is taxable to the decedent's gross estate.[6]

The entire subject is governed by section 2033 of the Internal Revenue Code, which provides that "[t]he value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."[7] In applying this to life estates, the courts have held that a life estate is not an interest which passes at death. For example, in *May v. Heiner*[8] the Supreme Court said, "At the death of Mrs. May, no interest in the property held under the trust deed passed from her to the living; title thereto had been definitely fixed by the trust deed. The interest therein which she possessed immediately prior to her death was obliterated by that event."[9]

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[4] ALI, FEDERAL ESTATE AND GIFT TAX PROJECT 184 (Study Draft No. 1, 1965) [hereinafter cited as ALI Study Draft No. 1].

[5] Alexander, *Federal Estate and Gift Taxation: The Major Issues Presented in the American Law Institute Project*, 22 TAX L. REV. 635, 641 (1967).

[6] 2 MERTENS §§ 14.40, 20.10.

[7] INT. REV. CODE of 1954, § 2033.

[8] 281 U.S. 238 (1929).

[9] *Id.* at 243. The Tax Court has incidentally passed upon the question of the inclusion of a life estate within the gross estate. In Estate of Susie C. Haggett, 14 T.C. 325 (1950), the court was passing upon the effect of an annuity contract. In analogizing the annuity to other life interests, the court said, "The present decedent's interest in the annuity contract *was that of a life beneficiary*. . . . We, therefore, hold that the respondent erred in including in the decedent's gross estate any part of the principal of the annuity contract." *Id.* at 330. The effect of a life estate upon the gross estate was also considered in Estate of Mary Clare Milner, 6 T.C. 874 (1946). There, the court made the following statement:

The failure to assess a tax on the termination of a limited interest created by a third party is the basis for the generation-skipping device. The exclusion results because an interest which terminates at the death of the decedent is not owned at death. This line of reasoning should apply to other limited interests which terminate prior to or at the death of the holder, such as the beneficiary's interest in a discretionary trust. Since such a limited interest created by a third party is not taxed upon the death of the beneficiary, generation skipping is possible.

State substantive law, however, provides some limits on this type of transfer. If the Rule Against Perpetuities did not exist, a grantor theoretically could grant infinite successions of life interests.[10] However, the Rule Against Perpetuities requires that vesting be assured not more than twenty-one years after the termination of the lives in being at the time of transfer.[11] This Rule reduces the time that generation-skipping grants may exempt the property from federal estate and gift taxation. However, the property may still escape taxation for about a century in many instances.[12]

If the generation-skipping transfer is made in the traditional life tenant-remainderman transaction, the grantor is unable to exercise much control over the donee's use of the property or provide for changed circumstances among the heirs, and therefore he may find generation skipping relatively undesirable. This inflexibility can be reduced somewhat by the use of conditional fees, determinable fees, and fees subject to divestment. However, these are also limited by state property law. The most common conditions individuals place on gifts or devises in order to exercise future control concern the donee's ability to alienate the property, the marital status of the donee and the ways the donee may use the property. Although a person may generally deed or will his property in any manner which he desires,[13] due to public policy the law has limited the power of the donor to impose these restrictions in certain instances.[14] A restriction which prevents the free alienation of a common law estate generally is void.[15] However, two common exceptions exist in Texas. The grantor may place property in a trust which includes a "spendthrift clause" without having the conveyance endangered.[16] Second, the lessee's interest in property may not be sold without the consent of the lessor.[17] Therefore, the grantor, if he so

> Under the settlement . . . the decedent . . . acquired nothing more than the right to the net income from an undivided one-half interest in the real estate during her life, or in other words, a mere life estate, and the remainder after such life estate was acquired by Gustrine Milner Jackson and Mary Clare Milner Morse and their lineal descendants. If . . . the latter two acquired such remainder interest from the estate of Gustrine Kay Milner, we see no reason for holding that . . . such remainder interest constituted 'any interest' in property of the decedent, . . . or any interest in property with respect to which she did or could make a transfer of the kind described in Section 811(c).

Id. at 883.

[10] JANTSCHER 25.

[11] L. SIMES, FUTURE INTERESTS 253 (2d ed. 1966).

[12] JANTSCHER 26.

[13] United States Nat'l Bank v. Snodgrass, 202 Ore. 530, 275 P.2d 860 (1954).

[14] *Id.*

[15] Pritchett v. Badgett, 257 S.W.2d 776 (Tex. Civ. App. 1953), *error ref.*

[16] Lindsey v. Rose, 175 S.W. 829 (Tex. Civ. App. 1915), *error ref.*

[17] Dillingham v. Williams, 165 S.W.2d 524 (Tex. Civ. App. 1942), *error ref.*; TEX. REV. CIV. STAT. ANN. art. 5237 (1962).

desires, should be able to restrict a grant for a term of years so that the grantee would be unable to sell it. In fact, absent such a restriction, the holder of a term interest may not be able to alienate his interest without the consent of the grantor, or his heirs or assigns, under a liberal reading of article 5237.[18]

A condition to discourage the remarriage of wives or the marriage of sons and daughters occasionally creeps into wills. A devise which conditions the vesting upon the persons divorcing their present spouse is void in *most jurisdictions*.[19] However, Texas allows such a devise if there is "no manifest intent to incite divorce."[20] Texas also allows devise to a wife with a condition divesting her of the property upon her remarriage.[21] Though some restrictions in this area are not allowed, in general any reasonable restrictions will be allowed,[22] and the courts are rather liberal in their definition of reasonable.[23]

A condition that property shall be used only for a particular purpose generally is valid.[24] A possible exception exists if the restriction as to use is repugnant to the Constitution of the United States or a state constitution.[25] The courts, however, do not favor these use restrictions and will hold them to represent covenants or expressions of intent rather than a limitation on the estate granted whenever possible.[26]

The only really important limitation on generation skipping imposed by the substantive law of property is the Rule Against Perpetuities. However, some transfers could cut across the other limitations imposed by the substantive law, and these must be considered where the grantor wishes to place conditions upon the grantee's freedom to deal with the property.

II. GENERATION-SKIPPING TRANSFERS

The Limited Interest. Life estates, term interests, and discretionary interests are common limited interests which can be given to the intermediate generation in order to avoid estate taxes. The life estate has been used often and has few of the problems which plague the other limited interests. It has the disadvantage of being inflexible and unable to take into account the changes in the circumstances of the individuals.[27]

The use of term interests in generation skipping has not been extensive, and, therefore, its relation to generation skipping is generally of an aca-

[18] TEX. REV. CIV. STAT. ANN. art. 5237 (1962).

[19] Fineman v. Central Nat'l Bank, 161 N.E.2d 557 (Ohio P. Ct. 1959).

[20] Hunt v. Carroll, 157 S.W.2d 429 (Tex. Civ. App. 1941), *error dismissed*; Ellis v. Birkhead, 71 S.W. 31 (Tex. Civ. App. 1902), *error ref.*

[21] Little v. Bridwell, 21 Tex. 597 (1858); Foote v. Foote, 76 S.W.2d 194 (Tex. Civ. App. 1934), *error ref.*

[22] Liberman v. Liberman, 279 N.Y. 458, 18 N.E.2d 658 (1939).

[23] *Id.*

[24] Gulf, C. & S.F. Ry. v. Dunman, 74 Tex. 265, 11 S.W. 1094 (1889); Jeffery v. Graham, 61 Tex. 481 (1858); Williams v. Box Church Baptist Church, 75 S.W.2d 134 (Tex. Civ. App. 1934), *error ref.*; Green v. Gresham, 53 S.W. 383 (Tex. Civ. App. 1899).

[25] Jeffries v. State, 212 Ark. 213, 205 S.W.2d 194 (1947).

[26] Hughes v. Gladewater County Line Independent School, 124 Tex. 190, 76 S.W.2d 471 (1934); Ryan v. Porter, 61 Tex. 106 (1884).

[27] Casner, *Property Disposition Under the Federal Estate and Gift Taxes*, in JOINT COMM. ON THE ECONOMIC REPORT, 85TH CONG., 1ST SESS., FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY 847 (Comm. Print 1955).

demic nature. It becomes a practical consideration, however, when legislation is proposed concerning limited interests.[28] The disadvantages of a term interest are considerably greater, and this probably explains its relatively rare appearance. For example, it is highly improbable that the beneficiary would die on the exact day the term ended. If death occurred before it ended, the interest in the remaining portion of the term would be included within the beneficiary's gross estate.[29] If the term ended before the death of the beneficiary, the grant would not adequately implement the probable desire of the testator to care for the beneficiary for life.

A more flexible interest which the grantor might transfer to the intermediate generation is a life interest in a discretionary trust. The interest which such a beneficiary possesses is totally controlled by the document creating the trust. The trustee may be provided with the power to determine the amounts of payments to the beneficiaries, whether any payments should be made, and even who will be beneficiaries. The power to select beneficiaries, however, must include at least "such a description . . . of the beneficiaries that they can be identified from extrinsic facts,"[30] or the trust will be void.[31] In addition, the trustees may not be given the power to select the grantor as a beneficiary if the trust is *inter vivos*, for this would result in the corpus being included in the grantor's gross estate at his death.[32] Further, if there is a single beneficiary, he may not be made the sole trustee since the legal and equitable titles would merge, and he would own the property in fee.[33] Despite these limitations,[34] the discretionary trust provides a highly flexible tool which allows the trustees to distribute the proceeds of the corpus according to the changing needs of the beneficiaries. When generation-skipping transfers are involved, this becomes extremely important since the length of time covered makes it difficult to provide an inflexible plan that will be appropriate to future conditions.[35]

Disposition of Remainder Interests. The remainder interest in the property which will vest in the next generation may be distributed in a number of ways. The simplest disposition is a grant in fee to the beneficiaries named in the instrument of transfer. The remainder may also be distributed by a special power of appointment, a power to invade the corpus according to an ascertainable standard, or limited powers of invasion. By giving these powers to the intermediate beneficiary or the trustee, the tax advantages are achieved, and the skipped generation retains much of the control over

[28] ALI Study Draft No. 1, at 128.

[29] Estate of A.E. Agnus, 17 B.T.A. 266 (1930), *rev'd on other grounds*, 46 F.2d 756 (4th Cir. 1931).

[30] 2 A. SCOTT, TRUSTS § 112 (2d ed. 1956).

[31] Davidson v. Wyman, 214 Mass. 192, 100 N.E. 1105 (Sup. Jud. Ct. 1913). A grant to the trustee to dispose of the remainder in "their absolute discretion" is void.

[32] Estate of Carolyn Pack Broadman, 20 T.C. 871 (1953).

[33] Cashion v. Cashion, 242 S.W.2d 468 (Tex. Civ. App. 1951), *error ref.*; TEX. REV. CIV. STAT. ANN. art. 7425b-7 (1960).

[34] Where the trustee has discretion to accumulate income, a possible accounting problem concerning income tax arises if the trustee should in any year pay out more than the income of the corpus since the five-year throw-back rule of INT. REV. CODE of 1954, § 666 is applicable in such a situation.

[35] Casner, *supra* note 27, at 854.

the property.

Special Powers of Appointment. Property subject to power of appointment is not included in the gross estate of an individual as long as it is not a general power of appointment as defined in section 2041 (b) (1) of the Internal Revenue Code.[36] A general power is one which may be exercised in favor "of the decedent, his estate, his creditors, or the creditors of his estate."[37] A special power is one which the donee may exercise only in favor of a particular class or enumerated individuals[38] and may not exercise in favor of himself, his estate, his creditors, or the creditors of his estate.[39] Since property subject to a special power is not included in the holder's estate, a grantor may give the intermediate beneficiary a special power of appointment in addition to one of the limited interests and still protect the property from taxation.[40] In this fashion the grantor may give his direct descendants almost complete control over the disposition of the remainder and still avoid the tax consequences of an outright gift to them.

Limited Power To Invade Corpus. If the property is put in trust, the beneficiary may also be given the power to invade the corpus in any given year to the extent of the greater of five per cent of the corpus or $5,000 under section 2041 (b) (2).[41] This power will not draw the entire corpus into the beneficiary's estate. However, upon his death, the beneficiary's estate will include the amount which could be obtained by the exercise of the beneficiary's power if he has not exercised it within the preceding year.[42]

In addition, possible income tax disadvantages arise when the five per cent or $5,000 clause is inserted. One complication is created by sections 671[43] and 678[44] of the Internal Revenue Code. Section 678 provides that, "A person other than the grantor shall be treated as owner of any portion of a trust with respect to which . . . such person has a power exercisable solely by himself to vest the corpus or income in himself."[45] Section 671 provides in part that, "No items of a trust shall be included in computing the taxable income and credits of the grantor or any other person solely on the grounds of his dominion and control over the trust under section 61 . . . or any other provision of this title, except as specified in this subpart."[46] Section 671 apparently was inserted to negate the "Clifford"[47] doctrine which provided that a person would be taxed on the income of a trust where "the corpus of the trust was so far subject to the taxpayer's unfettered dominion that it in substance was his . . . ."[48] The two sections together seem to indicate that if the trust has income and the possessor of the

[36] INT. REV. CODE of 1954, § 2041(b)(1).
[37] *Id.*
[38] L. SIMES, FUTURE INTERESTS 124 (2d ed. 1966).
[39] 26 C.F.R. § 20.2041-1(c)(1) (1961).
[40] 26 C.F.R. §§ 20.2041-1(c), 25.2514-1(1) (1961).
[41] INT. REV. CODE of 1954, § 2041(b)(2).
[42] 26 C.F.R. § 20.2041-3(a)(3) (1961).
[43] INT. REV. CODE of 1954, § 671.
[44] *Id.* § 678.
[45] *Id.*
[46] *Id.* § 671.
[47] Helvering v. Clifford, 309 U.S. 331 (1940).
[48] Richardson v. Commissioner, 121 F.2d 1, 3 (2d Cir. 1941).

power does not withdraw the five per cent or $5,000, he is taxed upon the income produced by that portion of the corpus although he never received the income, because under section 678 he had the power to vest in himself the corpus which produced that income.[49] For example, if five per cent of the trust would produce an income of $1,000 and the beneficiary had the power to withdraw five per cent of the corpus at his sole discretion, he would have to pay income tax on the $1,000 even though he never received it. However, if he possessed the power only in conjunction with some other person, he would not be taxed on the $1,000.[50]

Another possible income tax disadvantage arises under section 662, which provides that "There shall be included in the gross income of a beneficiary . . . (2) All amounts properly paid, credited, or required to be distributed to such beneficiary for the taxable year."[51] The regulations provide that, "There is included in the gross income of a beneficiary under section 662(a)(2) any amounts properly paid, credited, or required to be distributed to the beneficiary for the taxable year, other than . . . amounts in excess of distributable net income."[52] Therefore, it would seem that if the trust has income which is not distributed and the possessor of the power does withdraw the five per cent or $5,000, the amount withdrawn will be subject to income tax to the extent that there was undistributed income in the trust. For example, if a trust had undistributed income of $4,000 and the beneficiary exercised his right to withdraw $5,000, the beneficiary would pay income tax on $4,000 even though his power was limited to the withdrawal of corpus. If the trust had not accumulated income, the beneficiary would not be taxed on the amount of corpus which he withdrew.[53]

No case has been found where the Commissioner made these contentions. However, the statutes raise the possibility that it could be asserted. Although the power of invasion has these possible disadvantages, it would greatly enhance the control which the intermediate beneficiary could exercise over the property.

Invasion of the Corpus Subject to an Ascertainable Standard. If a trust is created by the generation-skipping transfer, the remainder interest may also be distributed, at least in part, by giving the trustee power to invade the corpus for the benefit of the intermediate beneficiaries. However, if favorable tax advantages are to be obtained, a high degree of care must be used in selecting the trustee and in describing his power of invasion, especially if the trust is discretionary. It is clear that the grantor should never be selected as trustee of a discretionary trust. Section 2036 would pull the corpus back into his gross estate since he would have the "right . . . to designate the person, or persons who shall possess or enjoy the transferred property or income therefrom."[54] In addition, section 2038 concerning

[49] 26 C.F.R. § 1.671-3(b)(3) (1961).
[50] *But see* Rev. Rul. 67-241, 1967 INT. REV. BULL. No. 31, at 10.
[51] INT. REV. CODE of 1954, § 662(a)(2).
[52] 26 C.F.R. § 1.662(a)-3 (1961).
[53] Rev. Rul. 67-241, 1967 INT. REV. BULL. No 31, at 10.
[54] INT. REV. CODE of 1954, § 2036.

revokable transfers would reach the same result, because the decedent would have the power "to alter, amend, revoke, or terminate"[55] the transfer.

If the beneficiaries are the trustees of a discretionary trust, extraordinary care must be used in drafting the instrument to assure that their powers of invasion conform to the "ascertainable standard" under section 2041(b)-(1)(A).[56] The Code defines the ascertainable standard as "relating to the health, education, support, or maintenance of the decedent."[57] If the power to invade is not limited by an acceptable ascertainable standard, it will be considered a general power, and the corpus will be considered as part of the beneficiary-trustee's gross estate at his death.[58] This, of course, defeats the tax avoidance plan, and the slightest deviation is often fatal. For example, in *Strite v. McGinnes*[59] the corpus was included in a beneficiary's estate at death because as trustee he had the power to invade corpus for "reasonable needs . . . or comfort." Thus, if the beneficiary-trustee is given powers of invasion, care should be taken to track the language of the regulations, for any deviation presents the possibility that the right to invade will be considered a general power.[60]

Conclusion. The limited and remainder interests may be used in various combinations. The use of the traditional life tenant-remainderman arrangement produces a disposition that is completely inflexible from the time the conveyance takes effect.[61] Changes in the circumstances of the beneficiaries may not be taken into account as the future becomes the present. In addition, the inflexible characteristics of the life tenant-remainderman transfer are somewhat undesirable, since the intermediate beneficiaries have little control over the final disposition of the property.[62] The combined use of a discretionary trust with special powers of appointment allows generations to be skipped and still enables the intermediate beneficiaries to retain a great amount of control. However, if the intermediate beneficiary is also to be trustee and thus gain maximum control, the trust must be carefully drafted.[63]

Many traps for the unwary exist in this area, and the presentation here is somewhat oversimplified. However, the testator's wishes may be successfully fulfilled by the use of transfers which allow maximum flexibility during the life of the trust and in the final disposition of the remainder.

III. ARGUMENTS FOR AND AGAINST CHANGE

As with most situations, two views exist as to the advisability of changing the tax structure to prevent generation-skipping transfers. Although

[55] *Id.* § 2038.
[56] *Id.* § 2041(b)(1)(A).
[57] *Id.*
[58] *Id.* § 2041(b).
[59] Strite v. McGinnes, 330 F.2d 234 (3d Cir. 1964).
[60] 26 C.F.R. § 20.2041-1(c)(2) (1961). A power to use property for comfort, welfare, or happiness is not limited by the required standard.
[61] Casner, *supra* note 27, at 853.
[62] *Id.* at 854.
[63] Estate of Josephine B. Lanigan, 45 T.C. 247 (1965).

most experts in the estate tax field agree that the present system has some problems, some believe that changing the present system would create more problems than it would solve.

The major argument for change is that the present system creates an inequitable situation. For example, if a man with one child had an estate of $500,000, and only testamentary transfers were made, then, after estate taxes, $255,224 of the corpus could be transferred to the third generation. Conversely, if a man with one child had an estate of $500,000 and transferred it by a generation-skipping device in which the child was made discretionary beneficiary, a co-trustee, and had a power to invade the corpus to the extent of five per cent or $5,000 and in which the trustees had the power to invade according to an ascertainable standard, $354,000 would remain after estate taxes to be transferred to the third generation. The power that each intermediate beneficiary possessed gave him almost complete control over the property. Therefore, when the beneficiary in the second transfer escapes taxation for estate taxes upon his death, the result is an inequality in the tax statutes.[64] Those who oppose the change simply point out that the beneficiary in the second transfer does not own the property to which the limited interest attaches. Therefore, a tax upon the beneficiary with respect to the transfer of property which he does not own would be unfair.[65]

The proponents of change have two important points. When generation skipping occurs, the lack of a tax in the first succeeding generation reduces the tax base by fifty per cent. Furthermore, if two generations are skipped, the tax base is reduced to one-third of what it would have been if there had been no generation skipping. Therefore, the revenue producing ability of the tax is impaired.[66] Finally, the present law and the loopholes that exist could tend to encourage long-term trusts. Since trusts are noted for their conservative investment requirements, these long-term trusts tend to drain risk capital from the economy, which could affect the continued growth and stability of the economy.[67]

The opponents of a change in the present law point out that most of the proposals for change either impose a penalty[68] for using a generation-skipping transfer or are extremely complicated.[69] In view of these facts, many transfers in trust might be discouraged. This could be detrimental because there are valid non-tax reasons for using generation-skipping trusts. Finally, such a drastic change in the federal estate and gift tax statute would result in an era of confusion. Instruments drawn under the old law and coming into operation after the change could dispose of property in an inappropriate manner. A time lag would invariably occur between the

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[64] ALI Study Draft No. 1, at xxxii.

[65] Eisenstein, *The Rise and Decline of the Estate Tax*, in JOINT COMM. ON THE ECONOMIC REPORT, 84TH CONG., 1ST SESS., FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY 819 (Comm. Print 1955).

[66] STAFF OF JOINT ECONOMIC COMM., 88TH CONG., 2D SESS., THE FEDERAL TAX SYSTEM: FACTS AND PROBLEMS (Comm. Print 1964).

[67] *Id.*

[68] SHOUP 46-48.

[69] Casner, *American Law Institute Federal Estate and Gift Tax Project*, 22 TAX L. REV. 515-75 (1967).

effective date of a change and an adequate interpretation by the courts so that attorneys could not be confident of the results of an instrument until many years had passed.[70]

Each of these factions makes its arguments with considerable force. Congress, while recognizing the shortcomings of the present law, has not yet found an alternative which it feels will remedy the situation.

The British System. In Great Britain, the termination of a life estate is a "passing" of property.[71] The interest which is taxed is the whole value of any property which finally vests in possession because of the decedent's death.[72] Accumulations within a trust have not been extensively discussed, but apparently they are taxed upon the death of the life beneficiary or the last contingent beneficiary; therefore, they do not escape the tax.

The tax may be paid from either of two possible funds, depending on the situation.[73] If the personal representatives of the deceased are accountable, they must pay the tax out of the estate. When the personal representatives are not responsible, every person who receives a beneficial interest is liable for the tax to the extent of property actually received.[74]

IV. Proposals for Taxing Generation-Skipping Transfers

The proposals to tax generation-skipping transfers generally suggest a tax on the property at the time the limited interest expired or at the time property was transferred by the donor in such a way that generations would be skipped. Four different types of proposals have been considered. They are the British system, a succession tax, an additional tax, and the changing of the present law with respect to powers of appointment.

In studying these proposals, three main problems must be kept in mind. First, how does the proposal define the interest which it would attempt to tax? Features which should be especially noted are the taxable event and the fund from which the tax is payable. Second, how does the proposal handle an interest in discretionary trusts? Finally, how does the proposed system of taxation handle accumulation trusts?

Two glaring problems exist within the British system. If the property is left in a discretionary trust, no estate tax is due until the next-to-last beneficiary dies and the last beneficiary becomes entitled to the whole income. Moreover, the tax falls upon the corpus of the trust or upon the property to which the life interest attached. Although taxation of a life interest may be desirable, the taxation of the whole corpus seems inequitable since the individual was never the owner of the capital and did not have control over it during his life. This over-taxation probably would make the British system inapplicable in the United States.[75]

[70] Alexander, *supra* note 5, at 636.

[71] JANTSCHER 163.

[72] Dworkin, *Estate Taxation in Great Britain*, in ESTATE AND GIFT TAXATION, A COMPARATIVE STUDY 68 (G. Wheatcroft ed. 1965).

[73] *Id.* at 82.

[74] The rate of taxation is the rate applicable to the deceased beneficiary's estate on the whole value of the corpus.

[75] Wheatcroft, *Proposals for a System of Estate and Gift Taxation,* in ESTATE AND GIFT TAXATION, A COMPARATIVE STUDY 134 (G. Wheatcroft ed. 1965).

The Succession Tax. The succession tax suggested by the American Law Institute is similar to the British system. It proposes a tax upon termination of the enjoyment of a beneficial interest.[76] The taxable event is the expiration of a limited interest such as a life estate, term of years, discretionary interest in a trust, or any other transfer.

Any transfer of a beneficial interest is excluded from taxation if the property has been subjected to the succession tax in the last thirty years.[77] The drafters of the ALI proposal believe that this system would successfully tax the interests which are presently escaping taxation by generation-skipping transfers.

The discretionary trust which has defeated the British estate tax is handled in detail. The ALI proposal would consider a person as having an interest in a discretionary trust if he ever received benefits from it.[78] Therefore, upon the death of each beneficiary, a taxable event would occur. The deceased beneficiary's interest in the corpus would be based upon the proportion of the beneficial enjoyment which he received from the trust in relation to the total benefits which had been dispensed by the trust. Thus, if a trust with a corpus of $100,000 paid $100 to each of three possible beneficiaries, upon the death of one beneficiary, a succession tax would be due upon one-third of the corpus.[79]

The problem of an accumulation trust is solved by placing a tax upon a mandatory accumulation trust every thirty years. Presumably, this is intended to discourage the long-term accumulation trusts.

The ALI proposals place the tax at the most logical time, the passing of the interest. However, the ALI dropped the succession tax proposal from its Study Draft No. 2, probably because of the complicated nature of the tax and possible administrative problems which were discovered.

The Additional Tax. Another proposal is to impose an additional tax over and above the gift or estate tax if the grantor or decedent places property in a generation-skipping transfer.[80]

The basic features of the tax are different from those which have traditionally existed in the gift and estate tax field. The taxable event would be the passing of the property to the intermediate beneficiary. Therefore, no tax would be due upon the expiration of the beneficiary's interest. The tax would be payable from the estate of the grantor. The liability would be

[76] ALI Study Draft No. 1, at 118.

[77] *Id.* at 170.

[78] *Id.* at 134.

[79] Jantscher has proposed a tax on the expiration of a limited interest which takes the problem of valuation into consideration. He would value the limited interest by discounting the income actually received. This might result in no taxation of accumulations in the trust. JANTSCHER 172-78.

Wheatcroft also has a proposal which is not so well defined. He would tax the actuarial value of the interest at the beginning of the interest. However, the taxable event would be the death of the beneficiary. If the interest were a discretionary one or if a trust accumulated income, the tax would be imposed every five years at a penal rate. Wheatcroft, *supra* note 75.

[80] ALI, FEDERAL ESTATE AND GIFT TAX PROJECT 106-21 (Study Draft No. 2, 1966) [hereinafter cited as ALI Study Draft No. 2]. For example, if the property passed by a testamentary generation-skipping transfer, the total tax due would be the estate tax plus the additional tax. If the property passed by an *inter vivos* generation-skipping transfer, the total due would be the gift tax plus the additional tax.

similar to the present gift tax.[81]

The difficulties associated with the additional tax are numerous but probably not insurmountable. The problems of the discretionary trust and the accumulation trust are thought to be solved by the initial tax. However, the taxation of transfers traditionally has taken place at the time the property is transferred. The public is accustomed to this type of taxation.[82] The additional tax is paid at the time the future passing of a beneficial interest becomes mandatory but before the passage of the property. Therefore, there could be some problem in public acceptance. Also, the additional tax might tend to discourage the transfer of property into certain types of generation-skipping trusts.[83] The trust was not initially developed for tax advantages, and valid reasons exist for the use of a certain number of generation-skipping transfers.[84] The tax, however, might prevent the use of the device when it is appropriate if an additional tax upon the property were considered as a penalty.[85] This is perhaps the main objection, and this objection could have great impact upon the public acceptance of the tax.

This tax apparently would be easier to administer than the succession tax. It also has the advantage of being easier for the layman to understand. However, it looks like a penalty.

Changing the Present Statute Relating to Powers of Appointment and Invasion of Corpus. The controversy over generation skipping apparently arose because of the great amount of control which the intermediate beneficiary could be given over the corpus and still not be subject to estate taxes upon his death. This situation possibly could be eliminated by some change in the law relating to powers of appointment and invasion of corpus.[86] All powers, both general and special, could be brought into the gross estate of the holder. However, this probably is not desirable since such a change would deter the use of powers where they are appropriate and would cause problems with many outstanding instruments. Congress also could provide that only the property subject to special powers exercisable in favor of a limited number of beneficiaries would be excluded from the gross estate of the holder. However, this would be ineffective to stop generation skipping since most special powers are in fact only exercised in favor of a limited number of beneficiaries, *viz.*, the descendants of the donee of the power. If the beneficiaries were limited to a specific number, generation skipping still would be possible, and an already technical statute would be more technical and unmanageable.

Finally, property subject to a special power could be included in the

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[81] The rate would have to be determined from a separate table. The rate would be progressively higher as the number of generations which the grantor skipped increased. ALI Study Draft No. 2, at 120.

[82] Casner, *supra* note 69.

[83] Alexander, *supra* note 5, at 671.

[84] Heslin, *Federal Estate and Gift Tax Proposals—Reformation or Deformation?*, 106 TRUSTS AND ESTATES 340 (1967).

[85] *Id.*

[86] Bittker, *Recommendations for a Revision of Federal Estate and Gift Taxes*, in JOINT COMM. ON THE ECONOMIC REPORT, 84TH CONG., 1ST SESS., FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY 864 (Comm. Print 1955).

gross estate if the holder of the power had a limited interest in the property subject to the power or was closely related to such a person. This would eliminate the great amount of control which the intermediate beneficiary can presently exert over the ultimate disposition of the corpus of a trust or remainder interests. Of the three changes described, this one seems most workable. However, such a change would be highly technical.

The objections which are raised in relation to the right to invade the corpus to the extent of the greater of five per cent or five thousand dollars could be eliminated by striking the provision from the statute. This would eliminate much of the control that the intermediate beneficiary can exercise over the corpus and would, in addition, make the Code less technical.

A change in the present law would probably be the most realistic approach. However, the change would in most cases make the Code more technical. Although such a change has been suggested, the Congress has not seen fit to adopt it.[87]

V. Conclusion

The federal estate and gift tax system initially was intended to tax the gratuitous transfer of all property. The loophole that allows generation skipping was completely unintentional. Therefore, to make the present tax more effective this loophole should be closed. The decision concerning which tax to adopt should be based upon the ease of administration and the acceptability and equity of the tax.

The succession tax probably would have few problems of acceptability since its timing is familiar. Taxation at the expiration of a limited interest would require considerable re-education of the public, lawyers, accountants, and the government. The succession tax probably would be more equitable, but this ultimately depends on the rate structure. However, the administration of the tax is its shortcoming. The definitional problems and the complexity of the statute probably would make interpretation and administration difficult.

The additional tax probably would be relatively easy to administer. The problems associated with definitions and which interests to tax are less complex than in the succession tax. However, the public probably would not accept the additional tax, since it looks like a penalty.

The suggested changes in the present law concerning powers of appointment would not eliminate the possibility of tax avoidance by generation skipping. However, the change would remove much of the flexibility from generation-skipping transfers. Without this flexibility, the desirability of such a transfer would be greatly reduced, and the tax avoidance by generation skipping should be reduced.

What changes should be made? The additional tax should be disregarded since it imposes what seems to be a penalty upon the transfer of property by generation skipping. Therefore, the choice is whether to enact stop-gap measures by changing the present system in relation to powers of appointment and invasion of corpus or to wait until the succession tax is perfected.

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[87] *Id.* at 870.