# Decluttering the Estate Tax

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Wendy C. Gerzog, *Toward a Reality-Based Estate Tax*, 57 **B.C. L. Rev.** 1037 (2016).

Where Marie Kondo taught us how to declutter our homes in *The Life-Changing Magic of Tidying Up*, Professor Wendy Gerzog provides in her article six proposals to declutter the estate tax. Author Kondo suggested that we examine each household item, ask whether it sparks joy, and then keep it only if we answer yes. Professor Gerzog writes that the estate tax should be more "reality-based," meaning that the estate tax "should encompass testamentary property transfers at their real values, and the marital and charitable deductions should reflect actual marital and charitable transfers." (P. 1037.) In her wide-ranging and thought-provoking article, Professor Gerzog examines certain "devices and distortions that have crept into the estate tax" (P. 1037.), discusses how each frustrates the goal of the estate tax, and then provides proposals to clear them from the estate tax.

The first device examined is the irrevocable life insurance trust (ILIT), the life insurance proceeds of which are excluded from the decedent's gross estate. Professor Gerzog has two proposed changes as to ILITs, the first being to amend § 2035 to "include in decedent's estate the full date of death proceeds of life insurance on the decedent's life to the extent to which the decedent has paid, directly or indirectly, insurance premiums within three years of his death" (this proposal is intended to include "any transfers by decedent to a trust within three years of death that in fact can be traced to the payment of life insurance premiums on decedent's life"). (P. 1042.) Professor Gerzog's second proposal is to amend § 2042 such that, except when surviving partners in a business partnership use insurance proceeds to buy a deceased partner's interest in the partnership, the decedent's gross estate includes life insurance proceeds paid on decedent's life to the extent to which the decedent at any time, directly or indirectly, paid the premiums on or irrevocably designated the beneficiary or beneficiaries of the policy. (P. 1043.)

Professor Gerzog persuasively argues that there are many fictions supporting ILIT proceeds being excluded from the decedent's gross estate, such as (1) the decedent never owning any of the incidents of ownership of the policy and (2) neither the decedent nor the decedent's estate receiving the life insurance proceeds. (P. 1039.) I find it elegant that Professor Gerzog seems, to me, to be applying a substance over form analysis to equate the estate tax's treatment of life insurance proceeds whether inside or outside an ILIT—either way, the taxpayer designates the beneficiaries (either of the policy or of the trust) and pays the insurance premiums (often using *Crummey* powers). Even though, in an ILIT, the taxpayer does not "own" the policy and does not receive the proceeds, the taxpayer does direct the life insurance proceeds to those individuals the taxpayer selects as beneficiaries. I appreciate Professor Gerzog's conclusion that "the ILIT is clearly a testamentary device and the value of the proceeds should be included in the decedent's estate." (P. 1043.) As a side note, I began to wonder whether there were any "costs" or "disadvantages" in the specific act of creating an irrevocable trust that would, perhaps, justify excluding ILIT life insurance proceeds. The oft-cited advantages to creating an ILIT seem, to me, to increase the taxpayer's control over the life insurance proceeds (i.e., providing asset protection to beneficiaries' creditors, increasing flexibility as to beneficiaries' governmental benefits, allowing for flexible trust distribution terms, and enabling GST planning). This increased control over the life insurance proceeds created and directed by the taxpayer through an ILIT, in my view, supports gross estate inclusion.

The second device addressed is the lifetime transfer with grantor-retained (1) lifetime income interest, (2) lifetime enjoyment over non-income producing property, or (3) power over lifetime income or enjoyment. Professor Gerzog's proposal is: "When a transferor splits a property interest and retains an income interest under § 2036, except where the transferee pays full and adequate consideration in money or money's worth equal to the value of the underlying fee interest in the property, the date-of-death value of the underlying property is included in the decedent's estate."

(Pp. 1048-1049.)

After analyzing the intent behind § 2036 and several cases interpreting it, Professor Gerzog insightfully concludes, "Someone who transfers a future interest in property to her child but retains the current enjoyment creates the split interest only to obscure the fact that she actually enjoys her property until her death when her child takes possession." (P. 1046.) She persuasively notes (1) actuarial taxable can be inaccurate because they assume a constant interest rate and ignore capital appreciation, (2) a taxpayer only splits a property interest when the probabilities favor (because of the taxpayer's personal situation) the use of the actuarial tables, and (3) transactions among unrelated third parties do not usually involve voluntarily splitting property interests. (Pp. 1047-48.) I admire Professor Gerzog's proposal, and I assume that her reference to the transferor who "retains an income interest under § 2036" includes transferors retaining, under § 2036, lifetime enjoyment over non-income producing property or power over lifetime income or enjoyment.

The third distortion examined is the usage of actuarial tables by such devices as the charitable lead annuity trust (CLAT) and grantor-retained annuity trust (GRAT). Professor Gerzog proposes: "When a transferor directly or indirectly divides a fee interest into temporal interests, the value of any future interest shall be determined and taxed at distribution to the beneficiary at the highest transfer tax rate." Similar to the foregoing second device, the donor-decedent-created partial interest is a strategy that transferors use "when the probabilities are skewed in their favor," making the actuarial tables "a non-neutral valuation tool." (P. 1050.) I can only admire Professor Gerzog's concise explanation for her proposal: "By timing the valuation to the date of possession, the real value of the property is known; by requiring the trustee to pay the transfer tax prior to distribution of the property, compliance rates should be high. By taxing the property at the highest transfer tax rate, there will be certainty, ease of calculation, and a further abuse deterrent." (P. 1052.)

The fourth distortion addressed is the taxpayer's intentional devaluation of property for transfer tax valuation purposes through such devices as the family limited partnership or family limited liability company. Professor Gerzog proposes: "Except in the case of an operating business, no discounts are allowed as to transfers of entity interests to family members with respect to any liquid assets transferred to that family entity." A transfer exempt from her proposal must be made in the ordinary course of business, meaning that the transfer must be bona fide, at arm's length, and without any donative intent. (P. 1053.).

The fifth and sixth distortions are the QTIP (qualified terminable interest property) provisions under the marital deduction and the CLAT provisions under the charitable deduction. Professor Gerzog proposes to repeal the QTIP statute (replacing it with a power of appointment trust), and, as to a CLAT when the property is distributed to the non-charitable donee, she proposes that the trustee shall pay a transfer tax, at the highest transfer tax rate, from trust assets at distribution. (Pp. 1058, 59) Professor Gerzog notes that the QTIP provisions allow for a marital deduction "without ceding control or ownership of the transferred property to the surviving spouse" and that the marital deduction "was intended to cover actual transfers of a fee property interest between spouses and was not intended for transfers of limited income interests to a spouse." (Pp.. 1056, 57-58) As to a CLAT, Professor Gerzog argues that the charitable deduction should be allowed "only where the deduction primarily benefits a charity and not where a split-interest transfer to a charity is designed to benefit mainly the non-charitable beneficiary." (P. 1058.)

This short review does not do justice to the breadth of issues discussed in Professor Gerzog's article. Each of her six proposals impressively builds upon the many articles she has written on these wide-ranging topics. I learned much from this and Professor Gerzog's other articles, all of which are things I like lots.

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