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Closing Gaps in the Estate and Gift Tax Base

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SUMMARY

Three transfer tax minimization mechanisms—zeroed-out grantor retained annuity trusts (GRATs), intentionally defective grantor trusts (IDGTs), and family-controlled entities with steep valuation discounts—significantly shrink the federal estate and gift tax base. This white paper explains how Congress can close all three loopholes. We estimate that these actions—along with complementary base-protecting and base-expanding proposals—would raise more than $65 billion over the fiscal year 2022 to fiscal year 2031 window (and possibly much more than $65 billion). They also would enhance the progressivity of the federal tax system and bolster the long-term revenue-raising capacity of the estate and gift taxes.

A separate white paper addresses reforms to the generation-skipping transfer (GST) tax, which exists to secure the estate and gift tax base and to check the growth of extraordinary fortunes in perpetual-life "dynasty trusts." Gaps in current law have allowed trillions of dollars to accumulate in dynasty trusts, potentially escaping federal transfer tax forever. The combination of reforms proposed here and in the accompanying white paper would enable the federal wealth transfer taxes to raise significantly more revenue in the short and long term while also curbing the continuing concentration of American wealth.

To summarize key conclusions:

- Congress should repeal section 2702(b)(1), the provision that enables high-net-worth individuals to achieve extraordinary transfer tax savings via GRATs;
- Congress should harmonize the income tax and transfer tax treatment of IDGTs, preferably by treating these trusts as nongrantor trusts for income tax purposes;
- Congress should limit lack-of-marketability discounts and eliminate lack-of-control discounts with respect to transfers of interests in family-controlled entities; and
- Congress should supplement these three reforms with additional base-protecting and base-broadening measures: shifting to a tax-inclusive base for gift taxes; limiting the gift tax annual exclusion for transfers in trust; and expanding the requirement of consistency in value for transfer and income tax purposes.

All of these steps remain relevant—and in some respects, even more urgent—if Congress enacts the Biden-Harris administration's capital income tax reform proposal, which would limit the tax-free step-up in basis at death to the first $1 million of unrealized gains ($2 million per

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couple). Unless Congress secures the estate and gift tax base, high-net-worth taxpayers will respond to stepped-up basis reform by exploiting transfer-tax loopholes even more aggressively. For this reason, estate and gift tax loophole closers and stepped-up basis reform should be considered complements, not substitutes. Together, the Biden-Harris administration's capital income tax reforms and the proposals outlined in these two white papers would help to ensure that very large fortunes face federal tax at least once per generation.

I. GRANTOR-RETAINED ANNUITY TRUSTS

A. Current Law and Reason for Change

When a grantor makes a transfer to an irrevocable trust, section 2702 allows the grantor to calculate the taxable gift amount by subtracting the value of any "qualified interest." Under section 2702(b)(1), "qualified interest" includes a term annuity retained by the grantor. The value of the retained annuity is calculated using the section 7520 rate (i.e., 120 percent of the federal midterm rate). These provisions have given rise to a highly effective transfer tax minimization strategy, known as a zeroed-out GRAT or "Walton GRAT." (The latter name comes from the case of *Walton v. Commissioner*,[1] in which the Tax Court rejected an IRS challenge to the Walton family's use of the strategy.)

To see how a zeroed-out GRAT can achieve significant transfer tax savings under current law, consider the following scenario: A taxpayer transfers $100 million to an irrevocable trust and retains a two-year term annuity entitling her to annual payments of $50.9 million. Based on the section 7520 rate in effect as of August 2021 (1.2 percent), the taxpayer's taxable gift would be zero, because the value of the two-year term annuity would be $100 million (thus zeroing out the amount of the gift).[2] If assets in the trust grow faster than 1.2 percent per year over the next two years, the GRAT will have assets left over at the end of the two-year period, and those assets will pass to the grantor's beneficiaries free of any transfer tax. If assets in the trust grow slower than 0.6 percent per year, the GRAT will be unable to make its final payment and will "fail," with no estate or gift tax consequences. Zeroed-out GRATs thus allow taxpayers to make a "heads I win, tails we tie" bet with the IRS.[3]

There is no limit to the number of zeroed-out GRATs a taxpayer may establish. Thus, in economic terms, the zeroed-out GRAT strategy allows a taxpayer to sell assets to her descendants repeatedly, with the purchase price paid exclusively from the assets themselves. When the assets substantially appreciate, the appreciation flows to the descendants. When they don't, the taxpayer takes the loss. Eventually, the bulk of the taxpayer's wealth is shifted to her descendants, with no gift tax paid.

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[1] 115 T.C. 589 (2000).

[2] See Rev. Rul. 2021-14, 2021-14 I.R.B. 982; Internal Revenue Service, Publication 1457, Actuarial Valuations: Version 3A, § 3 tbl.B (2009), https://www.irs.gov/pub/irs-tege/sec_3_table_b_2009.xls.

[3] See Daniel Hemel & Bob Lord, Beyond Lucrative: Jeffrey Epstein's Tax Avoidance Assistance Business, Inequality.org (Feb. 16, 2021), https://inequality.org/research/jeffrey-epstein-tax-avoidance.

GRATs give rise to tax consequences that are divorced from economic reality, as they assign a zero value for gift tax purposes to gifts that indisputably have economic value. This disconnect is problematic for three reasons. First, GRATs drain tens of billions of dollars in revenue from the federal government.[4] Second, GRATs undermine progressivity, since virtually all individuals who avoid estate and gift taxes via GRATs are in the top 0.1 percent of the income and wealth distributions.[5] Third, GRATs are inefficient. They serve no non-tax purpose. Anyone who genuinely wanted an annuity would purchase that product from a well-capitalized financial institution rather than from a thinly capitalized self-created trust. The costs of setting up and managing GRATs represent a pure deadweight loss.

B. Proposal

The most straightforward way to address the GRAT problem is to repeal section 2702(b)(1). This still would allow taxpayers to establish GRATs, but they could not use the value of the retained annuity to reduce their taxable transfers.

The Obama-Biden administration's FY 2017 Greenbook included an alternative GRAT reform proposal with two elements: (1) a minimum 10-year term for all new GRATs, and (2) a requirement that the remainder interest at the outset of a GRAT be at least equal to $500,000 or 25 percent of contributed assets (whichever is greater).[6] In practice, the difference between outright repeal and the FY 2017 Greenbook proposal is relatively small because if the FY 2017 Greenbook proposal became law, installment sales to intentionally defective grantor trusts (addressed below) would dominate GRATs as an avoidance strategy. Accordingly, the choice between outright repeal and the FY 2017 Greenbook proposal likely comes down to the simplification benefits of the former versus any political benefits of the latter.

C. Interaction with Biden-Harris Administration's Capital Income Tax Reform Proposal

The Biden-Harris administration's FY 2022 Greenbook would not directly amend any of the gift tax rules regarding GRATs. The administration's proposal would, however, alter the income tax rules in ways that are highly relevant to GRATs and other irrevocable trusts.

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[4] Richard Covey, who was counsel to Audrey Walon in *Walton v. Commissioner*, estimated in 2014 that zeroed-out GRATs had cost the federal government more than $100 million. See Zachary R. Mider, Accidental Tax Break Saves Wealthiest Americans $100 Billion, Bloomberg (Dec. 17, 2013), https://www.bloomberg.com/news/articles/2013-12-17/accidental-tax-break-saves-wealthiest-americans-100-billion.

[5] According to the most recent distributional estimates from the Treasury Department's Office of Tax Analysis, 93.2 percent of the estate and gift tax burden in 2022 will be borne by the top 0.1 percent of the income distribution. See U.S. Department of the Treasury, Office of Tax Analysis, Distribution Table: 2022 001 (2022 Income Levels): Distribution of Families, Cash Income, and Federal Taxes under 2022 Current Law (Apr. 20, 2021), https://home.treasury.gov/system/files/131/Distribution-of-Tax-Burden-Current-Law-2022.pdf. Less than 0.1 percent of people who die each year pay any estate tax under current law. See Tax Policy Center Briefing Book 410 (2020), https://www.taxpolicycenter.org/briefing-book/how-many-people-pay-estate-tax.

[6] U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals 180-82 (Feb. 2016), https://www.treasury.gov/resource-center/tax-policy/documents/general-explanations-fy2017.pdf.

Under current law, estate planners typically structure GRATs as intentionally defective grantor trusts (IDGTs), which we discuss in further detail in the next section. The result is that transfers to and distributions from GRATs are income tax non-events. By contrast, under the Biden-Harris administration's proposal for capital income tax reform, "transfers of property into, and distributions in kind from, a trust, … other than a grantor trust that is deemed to be wholly owned and revocable by the donor, would be recognition events."[7] As a result, transfers of appreciated property into a GRAT and distributions of appreciated property from a GRAT would generate capital gains tax liability. Although the potential for gift tax avoidance would remain the same as under current law, the acceleration of capital gains tax liability might make GRATs less attractive for some taxpayers.

For other high-net-worth taxpayers, however, the Biden-Harris administration's stepped-up basis proposal would potentially make GRATs even more attractive. Under current law, the primary disadvantage of GRATs is that when they succeed at shifting assets outside a taxpayer's gross estate, those assets become ineligible for tax-free stepped-up basis at death.[8] If Congress adopts the Biden-Harris administration's FY 2022 Greenbook proposal with respect to stepped-up basis at death, the primary tax disadvantage of GRATs—loss of tax-free stepped-up basis—would go away, at least for high-net-worth taxpayers who are well above the $1 million-per-person stepped-up basis exemption. For this reason, we think Congress ought to close the GRAT loophole regardless of whether it also adopts the Biden-Harris administration's capital income tax reforms.

II. INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

A. Current Law and Reason for Change

An intentionally defective grantor trust (IDGT) is a trust designed to be a grantor trust for income tax purposes but to fall outside the grantor's gross estate at death. Under current law, a grantor can engineer an IDGT by (among other methods) establishing an irrevocable trust but retaining the power to substitute assets in the trust for other property of equivalent value.[9] IDGTs open the door to several transfer tax minimization strategies:

- **Grantor payment of taxes on IDGT income:** A grantor can transfer income-generating assets to an IDGT and then, entirely consistent with the grantor trust rules, pay taxes on

[7] U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals 62 (May 2021), https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf.
[8] For very high net worth taxpayers, the advantages of GRATs (i.e., avoiding a 40 percent federal estate tax) generally outweigh the disadvantages (i.e., losing the opportunity to avoid long-term capital gains tax at a top federal rate of 23.8 percent). But in states with high top income tax rates and no estate taxes (in particular, California, where the top federal-plus-state rate on long-term capital gains is 37.1 percent), the income tax costs of losing stepped-up basis are sufficiently close to the estate tax benefits as to deter taxpayers from using GRATs for low-basis assets.
[9] I.R.C. § 675(4).

the IDGT's income herself. Under Revenue Ruling 2004-64, the grantor's tax payments are not considered taxable gifts.[10] In effect, the grantor is conferring an additional benefit on the IDGT (i.e., income tax relief), but with no gift tax consequences.

- **Installment sale to an IDGT:** A grantor can sell discounted assets to an IDGT in exchange for an installment note. The sale will be disregarded for income tax purposes as a transaction between the grantor and herself. The interest rate on the note will typically be the relevant section 1274 rate (which in August 2021 is 1.0 percent for loans of 3 to 9 years).[11] Because the grantor pays the income tax on IDGT assets, any income from or appreciation of IDGT assets above the installment-note rate will pass to trust beneficiaries free of estate and gift tax.
- **Deathbed swaps:** A grantor can borrow cash shortly before death and then swap that cash with the IDGT for appreciated assets of equivalent value. The appreciated assets will then end up in the grantor's estate at death and will receive stepped-up basis. The estate then can sell the assets with no income tax consequences to repay the grantor's debts. Although assets in the IDGT do not formally receive stepped-up basis, the result is economically equivalent to a basis step-up for IDGT assets because the IDGT will be left holding cash.

In recent years, some estate planners have advised high-net-worth families to take the even more aggressive step of claiming stepped-up basis with respect to assets in an IDGT at the time of the grantor's death, despite the fact that IDGT assets are excluded from the grantor's gross estate.[12] The IRS chief counsel's office roundly rejected this contention in 2008 advice,[13] and the claim that assets in an IDGT generally receive stepped-up basis upon the grantor's death lacks statutory support.[14] However, it may be difficult for the IRS to determine—except through an extensive audit—whether assets sold after the grantor's death passed through an IDGT. Our understanding is that some high-net-worth families—emboldened by favorable tax opinions from seemingly reputable law firms and the relatively low overall audit rate—therefore claim stepped-up basis on assets held by an IDGT at the time of the grantor's death.

Like GRATs, IDGTs undermine the progressivity and revenue-raising potential of the estate and gift taxes.[15] IDGTs also undermine the income tax because deathbed swaps (or, more boldly, claims by taxpayers that assets in IDGTs generally receive stepped-up basis) reduce future income tax collections from the trust's sale of appreciated assets. And, like GRATs, IDGTs generate wasteful transactions that serve no non-tax purpose.

[10] See Rev. Rul. 2004-64, 2004-2 C.B. 7.

[11] See Rev. Rul. 2021-14, 2021-14 I.R.B. 982.

[12] See Jonathan G. Blattmachr, Mitchell M. Gans & Hugh M. Jacobson, Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death, 97 J. Taxation 149 (2002).

[13] CCA-111831-08 (Nov. 18, 2008), https://www.irs.gov/pub/irs-wd/0937028.pdf.

[14] See Austin Bramwell & Stephanie Vara, Basis of Grantor Trust Assets at Death: What Treasury Should Do, Tax Notes, Aug. 6, 2018, at 793, 797.

[15] The two strategies are often employed in tandem: GRATs themselves are typically structured as IDGTs, as are the trusts that receive the GRAT remainder. This allows the grantor to pay income taxes on GRAT/IDGT income and to reduce the trust's ultimate capital gains tax liability by executing the deathbed-swap strategy.

B. Proposal

The most straightforward way to address the IDGT problem is to deny grantor trust status to any domestic trust that would be outside the grantor's gross estate at death. This would mean that former IDGTs would file as separate taxpayers subject to the general rules of subpart J in taxable years starting after December 31, 2021. Under this proposal, any income taxes paid by the grantor on income generated by a former IDGT would constitute an additional taxable gift. Installment sales to former IDGTs, deathbed swaps with former IDGTs, and all other transactions between an IDGT and its grantor would be recognition events for income tax purposes.

The Obama-Biden administration's FY 2017 Greenbook included an alternative IDGT reform proposal that would approach the problem from the opposite direction: it would include a portion of IDGT assets in the estate of the grantor at death if the trust engages in any sale, exchange, or comparable transaction with the grantor that is disregarded for income tax purposes.[16] In other words, it would preserve the current income-tax status but not the current estate-tax status of IDGTs, whereas the proposal here would preserve IDGTs' current estate-tax status but not their current income-tax status. The amount included in the grantor's gross estate would be the portion of the trust attributable to property received by the trust in the disregarded transaction, including appreciation, net of the amount of consideration received by the grantor.

The proposal here has three advantages over the FY 2017 Greenbook proposal. First, under the FY 2017 Greenbook proposal, grantors could continue to pay income taxes on IDGT income without triggering additional gift tax obligations. Under the proposal here, they could not. Second, because the FY 2017 Greenbook proposal would include IDGT assets in the grantor's estate *net of consideration received by the grantor*, the Greenbook proposal would not stand in the way of the deathbed-swap strategy described above. Deathbed swaps still could be used to move appreciated assets back into the grantor's gross estate so as to qualify for stepped-up basis, and these swaps would not generate any additional estate tax liability. Third, the proposal here would be much simpler to administer. The Greenbook proposal, by contrast, would require tracing trust assets over time (potentially decades) to determine which portion of an IDGT's property is attributable to disregarded transactions and which is attributable to outright gifts. The simpler approach proposed here would reduce compliance burdens on estate executors while also making it easier for IRS examiners to detect noncompliance.

In addition to the grantor trust reform described above, Congress should require taxpayers to disclose if they are claiming stepped-up basis with respect to assets that were in an IDGT at the time of the grantor's death. The disclosure requirement should be coupled with stiff penalties for taxpayers and their advisers to deter the behavior. The strategy of claiming stepped-up basis with respect to assets in an IDGT at the time of the grantor's death is unlawful, but we expect that some high-net-worth families will continue to exploit this strategy unless Congress, Treasury, and the IRS take decisive action.

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[16] FY 2017 Greenbook, supra note 6, at 181.

C. Interaction with Biden-Harris Administration's Capital Income Tax Reform Proposal

The Biden-Harris administration's capital income tax reform proposal would represent an important step toward addressing transfer tax avoidance opportunities involving IDGTs, but it would not close all such opportunities.

As noted above, the Biden-Harris administration's FY 2022 Greenbook would treat any transfer to or distribution from an irrevocable trust as a recognition event. However, it would not change any of the other income tax grantor trust rules. It would thus create a new type of "super-hybrid" trust that is (1) outside the grantor's estate for transfer tax purposes and (2) separate from the grantor for gain-recognition purposes but (3) not separate from the grantor for other income tax purposes.

As long as Revenue Ruling 2004-64 remains in place, a grantor of a super-hybrid trust still would be able to pay income tax on gains generated by the trust without incurring any additional gift tax liability. Indeed, the gift tax benefit of IDGT status under Revenue Ruling 2004-64 (i.e., the fact that the grantor can pay the trust's income taxes without incurring additional gift tax liability) would be even larger as income tax rates rise. Installment sales to IDGTs would become gain recognition events for income tax purposes under the Biden-Harris proposal, but the primary income tax disadvantage of IDGTs under existing law—loss of tax-free stepped-up basis at death—would cease to be a disadvantage for high-net-worth taxpayers once tax-free stepped-up basis is limited to $1 million per person.

For grantors who die after the effective date of stepped-up basis reform, deathbed swaps of low-basis IDGT assets for high-basis assets inside the estate no longer would deliver income tax advantages to beneficiaries (assuming the grantor's $1 million exemption under the Biden-Harris proposal already would be exhausted). For grantors who die before the effective date, however, beneficiaries still may attempt to claim stepped-up basis with respect to IDGT assets.

Note that if a grantor dies before the effective date of stepped-up basis reform (January 1, 2022 under the Biden-Harris administration's proposal), it may be several more years before beneficiaries sell assets that were in an IDGT at the time of the grantor's death. Therefore, the concern about beneficiaries claiming stepped-up basis with respect to IDGT assets remains for a time even after stepped-up basis reforms take effect. Indeed, the incentive to engage in this strategy would be even stronger after top capital gains tax rates rise. It therefore remains essential that Congress, Treasury, and the IRS take action to ensure that taxpayers do not continue to exploit this illegal shelter.

III. VALUATION DISCOUNTS FOR FAMILY-CONTROLLED ENTITIES

A. Current Law and Reason for Change

Under current law, high-net-worth individuals can use family-controlled entities to significantly reduce transfer tax liabilities. The Tax Court's recent decision in *Grieve v. Commissioner* provides a vivid illustration of this strategy in action.[17] The IRS's loss in *Grieve* underscores the urgent need for legislative change.

Grieve involved a Delaware LLC with two classes of interests: Class A voting units, which represented 0.2 percent of the ownership interests in the LLC, and Class B nonvoting units, which represented the remaining 99.8 percent of ownership interests. The taxpayer (through a revocable trust) held all the Class B units, and a partnership run by his daughter held the Class A units. Under the LLC agreement, Class B units could not be transferred to anyone other than a member of the taxpayer's family, a trust for the benefit of the taxpayer's family, or a charitable organization, unless all Class A unit owners consented.

The taxpayer transferred approximately $8 million of publicly traded stock and $1 million of cash to the LLC. The taxpayer then transferred all of his Class B units to a zeroed-out GRAT. The taxpayer claimed that the Class B units transferred to the GRAT had a value of approximately $5.9 million, even though the Class B units represented a 99.8 percent ownership interest in an LLC with assets of approximately $9 million. The taxpayer's valuation expert argued the value of the Class B units should be discounted by 13.4 percent to reflect the taxpayer's lack of control over the LLC, and then by an additional 25 percent to reflect the lack of marketability of the Class B units.[18] Over the IRS's objection, the Tax Court accepted the taxpayer's valuation.

The result in *Grieve* shows that taxpayers can achieve extraordinary valuation discounts—disconnected from economic reality—even when all of the assets in a family limited partnership or family LLC are easily marketable assets (e.g., cash or publicly traded stock). As with GRATs and IDGTs, steep valuation discounts for transfers of interests in family-controlled entities undermine the progressivity and revenue-raising potential of the estate and gift taxes. The costs of the transactions that allow taxpayers to claim these valuation discounts also amount to pure waste from an efficiency perspective.

B. Proposal

Legislation introduced in spring 2021 by Senator Bernie Sanders of Vermont and Representative Jimmy Gomez of California includes a well-designed two-pronged plan to address abusive valuation discounts.[19] First, with respect to the transfer of any non-actively traded interest in an entity, the value of any nonbusiness assets held by the entity would be determined

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[17] T.C. Memo 2020-28.

[18] Because the discounts were applied sequentially, they amounted to a total discount of approximately 35 percent from the net value of the LLC's assets: (1 – 0.134) x (1 – 0.25) ≈ 0.65. Thus, the transfer of approximately $9 million in assets was valued for gift tax purposes as a transfer of approximately $5.9 million. The combination of this strategy with a zeroed-out GRAT meant that the transaction was almost assured to result in assets passing to beneficiaries gift-tax-free, without consuming any of the taxpayer's lifetime exemption.

[19] For the 99.5 Percent Act, S. 994, 117th Cong., 1st Sess. (Mar. 25, 2021); For the 99.5 Percent Act, H.R. 2576, 117th Cong., 1st Sess. (Apr. 15, 2021).

as if the transferor had transferred the assets directly to the transferee, with no valuation discount. For example, in the *Grieve* case, the Delaware LLC units would be considered non-actively traded interests and so would be subject to the new rule. The cash and stock held by the Delaware LLC would be considered nonbusiness assets (i.e., assets not used in the active conduct of a trade or business). The Class B units would then be valued for transfer tax purposes as if the taxpayer had transferred $8 million of stock and $1 million of cash directly to the GRAT, resulting in a taxable gift of $9 million. Second, under the Sanders-Gomez proposal, lack-of-control and lack-of-marketability discounts would be disallowed for transfers of interests in entities controlled or majority-owned by the family of the transferor and/or transferee.

The Sanders-Gomez proposal builds upon an item in the Obama-Biden administration's FY 2013 Greenbook related to family-controlled entities.[20] Under the Greenbook proposal, a restriction on the liquidation of an interest in a family-controlled entity would be disregarded for transfer tax valuation purposes if, after the transfer, the restriction will lapse or may be removed by the transferor and/or her family. The Sanders-Gomez proposal strengthens the Greenbook proposal in two ways. First, the Greenbook proposal still would leave the door open to lack-of-marketability discounts for interests in family-controlled entities whose assets consist entirely of cash and marketable securities. The Sanders-Gomez proposal would abolish lack-of-marketability discounts for those entities. Second, the Greenbook proposal would allow for lack-of-control discounts as long as taxpayers installed liquidation restrictions that would not lapse and could not be removed by family members. The Sanders-Gomez proposal would put an end to lack-of-control discounts for family-controlled entities entirely.

C. Interaction with Biden-Harris Administration's Capital Income Tax Reform Proposal

The FY 2022 Greenbook states that under the Biden-Harris administration's capital income tax reform proposal, "a transferred partial interest would be its proportional share of the fair market value of the entire property" for purposes of applying income tax at the time of gift or death.[21] The scope of this proposal is not entirely clear. The term "partial interest" appears in several places in the Internal Revenue Code, and it means different things in different places. For example, in section 613A—which sets forth limitations on percentage depletion with respect to oil and gas wells—the term "partial interest" explicitly includes partnership interests.[22] By contrast, in section 170 (which allows for charitable contribution deductions), "partial interest" refers to a variety of interests in real and personal property that fall short of fee simple ownership (e.g., a life estate, remainder interest, or easement).[23] Under the latter narrower definition, minority interests in an entity (e.g., partnership interests, LLC units, and shares of stock in a corporation) would not be "partial interests." We urge Congress to clarify that lack-of-control discounts will be disallowed for all minority interests in family-controlled entities—both under the income tax laws and the estate and gift tax laws.

[20] U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals 79 (Feb. 2012), https://home.treasury.gov/system/files/131/General-Explanations-FY2013.pdf.
[21] FY 2022 Greenbook, supra note 7, at 62.
[22] I.R.C. § 613A(c)(2)(B).
[23] See I.R.C. § 170(f)(2); Treas. Reg. § 1.170A-7(d).

Additionally, we note that the language in the FY 2022 Greenbook would not explicitly prohibit lack-of-marketability discounts for non-actively traded interests in entities holding nonbusiness assets. For example, imagine that a high-net-worth individual places a portfolio of publicly traded stocks inside a single-member LLC with restrictions on liquidation. The individual then transfers 49 percent of the LLC units by gift. The FY 2022 Greenbook can be understood to suggest (under the broader definition of "partial interest") that the amount recognized for income tax purposes will be 49 percent multiplied by the fair market value of all the LLC units. However, the taxpayer still may argue that the fair market value of all the LLC units is less than the fair market value of the LLC's stock portfolio because the LLC units cannot be sold as easily as the individual stocks inside. We therefore urge Congress to include, as part of any comprehensive stepped-up basis reform, rules similar to the Sanders-Gomez proposal for non-actively traded interests in family-controlled entities holding nonbusiness assets.

IV. ADDITIONAL LOOPHOLE-CLOSING AND BASE-BROADENING MEASURES

Beyond the "big three" (GRATs, IDGTs, and valuation discounts), several other measures could close loopholes and further strengthen the estate and gift tax base:

Shift to a tax-inclusive base for gift taxes. Although the statutory gift tax rate is 40 percent, current law allows taxpayers to pay gift taxes with pre-gift-tax dollars. Thus, if an individual has exhausted her lifetime exemption and wants to set aside $140 for lifetime gifts and associated taxes, she can make a $100 gift and pay $40 in taxes (for an effective transfer-tax rate of 28.6 percent in tax-inclusive terms). By contrast, if an individual has exhausted her exemption and dies with $140 in her gross estate, she will pay 40 percent of $140 ($56) in estate taxes (for an effective transfer-tax rate of 40 percent in tax-inclusive terms).

Under current law, the costs of the misalignment between the effective gift-tax and estate-tax rates are mitigated by two factors: (1) high-net-worth taxpayers often can use zeroed-out GRATs, installment sales to IDGTs, and valuation discounts to minimize or eliminate transfer tax liabilities, thus obviating the need to pay any gift tax; and (2) high-net-worth taxpayers often prefer to transfer assets at death rather than through lifetime gifts in order to obtain the benefit of tax-free stepped-up basis. However, the landscape would shift significantly if (a) Congress eliminates zeroed-out GRATs, IDGTs, and valuation discounts, and (b) Congress adopts the Biden-Harris administration's proposal to limit tax-free stepped-up basis at death. Lifetime gifts then would become much more attractive, which would exacerbate the costs of the current misalignment.

Limit gift tax annual exclusion for transfers in trust. The gift tax annual exclusion ($15,000 per donee in 2021) was originally intended to reduce compliance burdens and leave room for relatively small, occasional gifts at holidays, birthdays, weddings, etc.[24] Over the last nine

[24] See Bridget J. Crawford, Reform the Gift Tax Annual Exclusion to Raise Revenue, Tax Notes, July 25, 2011, at 443, 444.

decades, the exclusion has morphed into a potent mechanism for tax minimization. To address this problem, the FY 2015, FY 2016, and FY 2017 Greenbooks proposed a new \$50,000-per-year limit on the exclusion for transfers in trust, transfers of interests in passthrough entities, and transfers of property subject to prohibitions on sale and restrictions on liquidation. Any such transfer over the \$50,000 threshold would not be eligible for the annual exclusion even if total gifts to each individual donee did not exceed the annual exclusion threshold.[25]

A simpler approach would be to provide that transfers in trust, transfers of interests in passthrough entities, and transfers of property subject to prohibitions on sale and restrictions on liquidation categorically cannot qualify for the annual exclusion. The annual exclusion was not intended to facilitate these sorts of transfers, and taxpayers still could apply their lifetime gift tax exemption to those transfers.

Expand requirement of consistency in value for transfer and income tax purposes. Congress in 2015 enacted a valuation consistency requirement for estate and income tax purposes,[26] but it did not extend the consistency requirement to property transferred by gift or property that qualifies for the estate tax marital deduction. Current law thus does not explicitly prohibit taxpayers from choosing a valuation below the donor's adjusted basis for gift tax purposes but then claiming for income tax purposes that the property had a higher value at the time of the gift.[27] Likewise, when property passes from one spouse to another upon the first spouse's death, current law does not explicitly prohibit the surviving spouse from claiming a higher adjusted basis than the fair market value reported on the first spouse's estate tax return. The Biden-Harris administration's capital tax reform proposal would largely eliminate opportunities for high-net-worth taxpayers to use inconsistent valuations abusively, because gifts would become realization events and assets passing from one spouse to the other at the first spouse's death no longer would receive a tax-free step-up in basis. However, if Congress fails to enact the administration's proposal, or if it raises the exemption level significantly above \$1 million per person, expansion of the valuation consistency requirement should remain a priority.

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[25] See U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals 171 (Mar. 2014), https://home.treasury.gov/system/files/131/General-Explanations-FY2015.pdf; U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals 204-05 (Feb. 2015), https://home.treasury.gov/system/files/131/General-Explanations-FY2016.pdf; FY 2017 Greenbook, supra note 6, at 188.

[26] I.R.C. § 1014(f).

[27] The typical rule for basis of property acquired by gifts is that the donor's adjusted basis carries over to the donee. However, when the fair market value of the property at the time of the gift is less than the donor's adjusted basis, the donee's basis is "stepped down" to fair market value for purposes of determining loss. I.R.C. § 1015(a).

A proposal in the FY 2017 Greenbook would extend the valuation-consistency requirement to property transferred by gift. FY 2017 Greenbook, supra note 6, at 179. The Greenbook did not clarify whether this requirement would apply only for purposes of determining loss or also for purposes of determining gain. We would suggest applying a modified valuation-consistency requirement for purposes of determining gain: basis of property received by gift could not exceed the value reported on a gift tax return, but basis still could be *lower* than the value reported on a gift tax return. The valuation-consistency requirement would therefore serve as a check on gift-tax undervaluation: a donor who claims a value on a gift tax return of less than her basis would thereby increase the donee's ultimate income tax liability.

V. REVENUE ESTIMATES

The FY 2017 Greenbook estimated that the Obama-Biden administration's GRAT and IDGT reform proposals would raise approximately $19 billion from FY 2017 to FY 2026 (around $23 billion from FY 2022 to FY 2031 if projected outward based on nominal GDP growth).[28] The FY 2013 Greenbook estimated that the Obama-Biden administration's valuation discount proposal would raise approximately $18 billion from FY 2013 to FY 2022 (around $25 billion from FY 2022 to FY 2031 if projected outward).[29] Adding those two figures together totals to $48 billion over the FY 2022-FY 2031 window.

Neither Treasury nor the Joint Committee on Taxation has estimated the revenue effect of shifting to a tax-inclusive gift tax base. However, we can arrive at a rough estimate as follows: For tax year 2017, the last year before the Tax Cuts and Jobs Act doubled the lifetime exemption, approximately $1.7 billion in total tax was reported on gift tax returns.[30] Including that $1.7 billion in the gift tax base would raise an additional $1.2 billion per year, before factoring in any behavioral changes or income growth.[31]

Behavioral changes would go in both directions. First, the higher effective tax rate would discourage lifetime gifts. However, the other changes outlined above—especially if combined with the Biden-Harris administration's capital tax reform proposal—would encourage lifetime gifts because (a) alternative opportunities for transfer tax avoidance would be limited and (b) the primary disadvantage of lifetime gifts (i.e., the loss of tax-free stepped-up basis) would disappear. Therefore, we consider $1.2 billion per year, or $12 billion over a 10-year window, to be a plausible lower bound on the revenue from shifting to a tax-inclusive gift tax base.[32]

The FY 2017 Greenbook further estimated that a cap of $50,000 per donor per year on gifts in trust that would qualify for the annual exclusion would raise approximately $4 billion over the FY 2017 to FY 2026 window.[33] Our proposal for a cap of zero would raise meaningfully more. Also

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[28] FY 2017 Greenbook, supra note 6, at 269. To update estimates from the first quarter of 2016 to the first quarter of 2021, we apply a 1.2x multiplier. See Federal Reserve Bank of St. Louis, Federal Reserve Economic Data, Gross Domestic Product (GDP), https://fred.stlouisfed.org/series/GDP (last updated July 29, 2021). To update estimates from the first quarter of 2012, we apply a 1.4x multiplier.

[29] U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals 203 (Feb. 2013), https://home.treasury.gov/system/files/131/General-Explanations-FY2013.pdf.

[30] Internal Revenue Service, Statistics of Income Division, Gift Tax Returns Filed in 2017: Total Gifts of Donor, Deductions, Credits, and Net Tax on Current Period Gifts, by Tax Status and Size of Taxable Gifts (Nov. 2018), https://www.irs.gov/pub/irs-soi/07gf01gr.xls.

[31] $1.7 billion in gift tax corresponds to approximately $4.3 billion in taxable gifts ($1.7 billion/0.4 ≈ $4.3 billion). For donors to make net gifts of $4.3 billion with a 40 percent rate and a tax-inclusive base, pre-tax gifts would have to equal $4.3 billion/(1 – 0.4) ≈ $7.2 billion. Additional gift tax, then, would be 40% * $7.2 billion – $1.7 billion) ≈ $1.2 billion.

[32] A further reason why the $12 billion figure should be considered conservative is that it does not account for the effect of post-2017 income growth.

[33] FY 2017 Greenbook, supra note 6, at 269.

according to the FY 2017 Greenbook, the simple fix of expanding the consistency requirement to the gift tax and the estate tax marital deduction would raise approximately $2 billion over a 10-year window.[34]

All in all, we have identified—conservatively—more than $65 billion in revenue raisers from estate and gift tax loophole closers and base expanders.[35] There are at least three reasons to expect that the revenue raised by the proposals here would be well above $65 billion over the 10-year window. First, the proposals here go further than the Obama-Biden Greenbooks on GRATs, IDGTs, and valuation discounts. Second, addressing GRATs, IDGTs, and valuation discounts in one fell swoop will raise more revenue than any one or two of these proposals would on their own. For example, if Congress abolished zeroed-out GRATs but did not address valuation discounts, GRAT users would presumably shift to valuation-discount strategies, limiting the revenue gain from addressing GRATs. Third, the Tax Court's very taxpayer-favorable decision in the *Grieve* case is likely to lead to more—and more aggressive—application of valuation discounts to family-controlled entities holding marketable securities. Thus, absent any legislative correction, the revenue loss from valuation discounts is likely to grow, in which case the revenue gain from valuation discount reform will rise as well.

Finally, the most significant revenue gains from the reforms outlined above will lie beyond the 10-year budget window typically covered by Greenbook revenue estimates. This is because many high-net-worth individuals in their 40s, 50s, and 60s who otherwise would have used GRATs, IDGTs, and family-controlled entities to make gift-tax-free lifetime transfers are likely to respond to these legislative changes by holding onto their assets (a phenomenon already accounted for in the Treasury revenue estimates). Since most of these individuals will live for more than a decade, the revenue gains from estate tax collections will appear outside the budget window. This may make it attractive to include these proposals in a budget reconciliation package because they can potentially be used to offset any revenue losses or outlay increases in out-years.

VI. CONCLUSION

This white paper has identified straightforward statutory changes that would close existing loopholes and protect the estate and gift tax base from further erosion. Based primarily on past Treasury estimates, we anticipate that the reforms identified here would raise more than $65 billion over the 10-year window (and potentially much more than that), along with even greater gains outside the 10-year window. The complementary reforms to the GST tax outlined in the accompanying white paper would secure the federal wealth transfer tax base over the long term. Combined, these reforms would raise significant revenue, ensure that extraordinary fortunes

[34] Id.

[35] $23 billion from GRAT and IDGT reforms; $25 billion from valuation discount reform; $12 billion from shifting to a tax-inclusive gift tax base; $4 billion from reform of the gift tax annual exclusion; and $2 billion from an expansion of valuation consistency rules. $23 billion + $25 billion + $12 billion + $4 billion + $2 billion = $66 billion.

bear a fairer share of the federal tax burden, and counter the threat to democratic equality posed by the accumulation of dynastic wealth.