

**THE FUTURE OF THE
FEDERAL WEALTH TRANSFER TAX SYSTEM:
REFORM OR REPEAL??**

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I. Present Federal Estate Tax Law¹

A. Types of Transfer Taxes

1. The Federal estate tax law is a tax on transfers of property at death. Federal tax law imposes three types of taxes on transfers of property. Chapter 11 of the Internal Revenue Code imposes a federal estate tax on transfers occurring at death, Chapter 12 of the Code imposes a federal gift tax on gratuitous transfers during lifetime, and Chapter 13 imposes a generation-skipping tax on certain transfers to grandchildren and others that skip a generation.
2. For estate tax purposes, assets subject to estate tax are generally all assets over which the decedent had possession or control. Assets subject to estate tax include, real estate, stocks, bonds, cash, life insurance, retirement benefits, annuities, tangible personal property, and all other property owned or controlled by the decedent. Jointly owned property is also subject to estate tax.

B. Unification of Estate and Gift Tax.

1. Since 1976, the federal gift tax and the estate tax have been unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death.
2. A unified credit is available with respect to taxable transfers by gift and at death. From 1987 to 1997, the unified credit was \$192,800, which effectively exempted from estate and gift tax a total of

¹ A significant portion of this paper is based on a report prepared by the Joint Committee on Taxation entitled Description and Analysis of Present Law and Proposals Relating to Federal Estate and Gift Taxation. This Report was released at a public hearing before the Subcommittee on Taxation and IRS Oversight of the Senate Committee on Finance on March 15, 2001.

\$600,000 in cumulative taxable transfers. The Taxpayer Relief Act of 1997 increased the effective exemption to \$675,000 in 2000 and 2001, \$700,000 in 2002 and 2003, \$850,000 in 2004, \$950,000 in 2005, and \$1 million in 2006 and thereafter.

3. For transfers made in 2004, the federal estate tax graduated rates begin at 45 percent and reach 48 percent on cumulative taxable transfers over \$1.5 million. For transfers made in 2004, the federal gift tax graduated rates begin at 41 percent and reach 48 percent on cumulative taxable transfers over \$1 million.
4. A 100 percent marital deduction is allowed for the value of property transferred between spouses whether during lifetime or at death. In addition, certain transfers in trust to a spouse also are eligible for the marital deduction if certain conditions are met. One of the most popular marital trusts are qualified terminable interest trusts (referred to as "QTIP Trusts"). A QTIP Trust is a trust in which the surviving spouse has an income interest for life and to which certain elections are made.
5. The Internal Revenue Code allows an unlimited estate and gift tax deduction for transfers to qualified charities.
6. A taxpayer may exclude \$11,000 of gifts made to any one donee during a calendar year. The annual exclusion is adjusted annually for inflation occurring after 1997. Married individuals may treat gifts made to any one donee as having been made one-half by the donor and one-half by the donor's spouse. This allows a married couple to exclude \$22,000 of gifts made to any one donee during a calendar year.

C. GST Exemption and Tax Rate on Generation-Skipping Transfers.

1. The generation-skipping tax is in addition to the gift and estate tax and is imposed on transfers to grandchildren and other beneficiaries more than one generation below the transferor.
2. The first \$1,500,000 of property transferred to grandchildren or others is exempt from the generation skipping tax. Transfers in excess of the GST exemption are subject to a flat tax rate of 48 percent in 2004.

D. Special Relief Provisions Available for Farms and Other Family Businesses.

1. The federal estate tax is based on the fair market value of the assets valued as of the date of the decedent's death. (The decedent's estate may elect to value the assets as of the date that is six months

after the decedent's death.) The estate tax is due nine months following the date of the decedent's death. If the decedent's estate consists of substantially farm real estate or a family business, there are special provisions available to decrease the amount and defer the due date of estate taxes.

2. Internal Revenue Code section 2032A allows the decedent's estate to value farm real estate based on its income rather than fair market value. The farm real estate must represent 25 percent of the decedent's estate and farm personal and real property must consist of 50 percent of the decedent's estate to qualify for the benefits of special use valuation. Under section 2032A, the maximum reduction in value in 2004 is \$850,000, which is adjusted annually for inflation. If the real estate is sold or no longer used by the family for farming within 10 years of the decedent's death, the section 2032A savings is recaptured and must be repaid by the decedent's heirs.
3. Although repealed effective in 2004, Internal Revenue Code section 2057 allows the decedent's estate to deduct the adjusted value of the qualified family-owned business interests of the decedent up to a total of \$675,000. A qualified family owned business interest is an interest in a trade or business where one family owns 50 percent of the business, two families own 70 percent, or three families own 90 percent, as long as the decedent's family owns at least 30 percent of the trade or business. The benefits of this deduction are recaptured if within 10 years the qualified business interest is sold or the decedent's family no longer participates in the operation of the business.
4. Internal Revenue Code section 6166 allows the decedent's estate to elect to pay the estate taxes attributable to an interest in a closely-held business in up to ten annual installments. If the election is made, the estate pays interest only for five years followed by ten annual installments of tax and interest. A special two-percent interest rate applies to the amount of the deferred estate tax attributable to the first \$1 million in taxable value of a closely-held business interest. The interest rate on the estate tax in excess of the first \$1 million in value is equal to 45 percent of the Federal short-term rate plus three percentage points. The decedent's interest in the closely-held business must exceed 35 percent of the decedent's estate to qualify for the benefits of the installment payment of estate tax.

E. State Inheritance and Estate Tax Law.

1. The 2001 Act reduces, and then eliminates, the federal credit for state death taxes over a period of four years, and replaces the credit with a deduction. In 2004, the credit is reduced by 75 percent of its historical amount and is eliminated in 2005.
2. Most states impose a death tax equal to the amount of the federal state death tax credit. With this type of state death tax system, the Internal Revenue Service in effect had administered and enforced the state death tax. Thus, a state that had a death tax equal to the federal state death tax required few employees to administer and enforce the collection of the tax. Some states have “anchored” the state death tax credit to a particular year before 2001. As a result of the 2001 Tax Act, the estates of individuals who are residents of states that have anchored their state death tax to a year earlier than 2001 will pay a significantly larger total estate tax bill than those individuals who are residents of pure state death tax credit states.

F. Present Income Tax Law.

1. A taxpayer who sells or otherwise dispose of property received by gift or inheritance needs to know the taxpayer’s basis in the property to determine the taxpayer’s gain or loss upon the disposition. Basis generally represents a taxpayer’s investment in the property.
2. Under present law, property received from a donor of a lifetime gift takes a carryover basis (the donor’s basis is “carried over” to the donee and the donee’s basis is the same as the donor’s basis). If the donor pays gift tax on the transfer of property (the cumulative transfers exceed the gift tax unified credit equivalent of \$1,000,000 for a single taxpayer or \$2,000,000 for married taxpayers), there is an adjustment to the basis for the amount of the gift tax paid on the transfer.
3. Stepped Up Basis. Under present law, property received from a decedent’s estate receives a basis equal to the fair market value of the property as of the decedent’s death. Because property inherited generally receives an increase in basis, it is said that property receives a stepped up basis at death.
4. The income tax considerations involved with property received by gift and inherited property can be significant. For example, assume Father purchases real estate in 1980 for \$100,000, Father gives the real estate in 2001 to his children when the real estate has a fair market value of \$500,000, and the children immediately sell

the property for \$500,000. The children's basis in the property for income tax purposes is \$100,000, the children will recognize capital gain of \$400,000, and pay \$160,000 in federal capital gains tax. Rather than giving the children the property, assume that Father dies owning the property, the children inherit the property with a fair market value of \$500,000, and the children immediately sell the property for \$500,000. In this instance, the children's basis is \$500,000, and the children will not pay any capital gains tax.

G. Federal Estate and Income Tax Treatment of Life Insurance.

1. For federal estate tax purposes, the proceeds of life insurance on the life of a decedent are included in the decedent's estate if the decedent: (a) owned the policy, (b) possessed any of the incidents of ownership over the policy or, (c) transferred the policy within three years of the decedent's death.
2. The earnings on the assets inside the insurance policy (referred to as the "inside buildup") are not subject to federal income tax. Also, the proceeds payable at death are not subject to federal income tax.

II. History of the Federal Estate Tax

A. The First U. S. Estate Tax.

1. Although many of the states used death taxes extensively, federal death taxes were imposed at first to finance wars. The first federal death tax was imposed from 1797 to 1802 to finance the development of strong naval forces. This tax was a stamp tax on inventories of deceased individuals, receipts of legacies, shares of personal estate, probates of wills, and letters of administration. After the repeal of the stamp tax in 1802, the next federal death taxes were a federal inheritance tax imposed from 1862 to 1870 to finance the Civil War.
2. The first federal estate tax was imposed in 1898 to finance the Spanish-American War. This tax remained in effect from 1898 to 1902. In 1906, President Theodore Roosevelt proposed a progressive tax on all lifetime gifts and bequests at death, but this proposal did not result in legislation.
3. In 1916, Congress enacted a progressive estate tax on all property owned by the decedent at death, certain transfers made during lifetime for inadequate consideration, transfers not intended to take effect until death, and transfers made in contemplation of death. Because the commencement of World War I caused revenues from tariffs to decrease, the Congress enacted an estate tax to replace the

lost revenue. The 1916 estate tax provided an exemption of \$50,000 and rates from 1 percent on the first \$50,000 of transferred assets to 10 percent on transferred assets in excess of \$5 million. Because of the increased need of revenue from World War I, Congress increased the top estate tax rate to 25 percent on transferred assets in excess of \$10 million.

4. In the Revenue Act of 1918, Congress reduced the estate tax rates on transfers under \$1 million, but extended the estate tax to life insurance proceeds in excess of \$40,000. In 1926, Congress repealed the gift tax and reduced the estate tax rates to maximum rate of 20 percent on transfers over \$10 million. During the 1930s, Congress was searching for revenue because of the Depression and Congress raised the estate tax rates and extended the tax to lifetime transfers in which the transferor retained a life estate. In addition, Congress reimposed the gift tax for cumulative lifetime gifts in excess on \$5,000 per year. The gift tax rate was 75 percent of the estate tax rate. In 1940, Congress added a 10 percent surcharge on both income and estate and gift taxes because of the need for additional revenue caused by the military buildup before World War II.

B. Modern Federal Estate and Gift Tax Laws.

1. In 1976, Congress substantially revised the estate and gift taxes by providing for a single unified rate structure for cumulative lifetime and death transfers and providing an exemption (called the “unified credit”) from tax. In addition, Congress changed the income tax rules applicable for the basis of inherited assets from a stepped-up basis to a carryover basis. With a carryover basis, the heir’s basis would be the same basis as the decedent’s basis. In 1980, the carryover basis rules were retroactively repealed and the estate tax stepped-up basis rules were reinstated.
2. In 1981, Congress changed the gift and estate tax rules by increasing the unified credit to effectively exempt the first \$600,000 of transfers from the estate and gift tax, reduce the top unified estate and gift tax rate from 70 percent to 50 percent and provided for an unlimited deduction for transfers to spouses.
3. In 2001, Congress enacted the Economic Growth and Tax Relief Reconciliation Act of 2001 (the “2001 Tax Act”) which turned the estate planning practice on its head.

C. The 2001 Tax Act

1. There will be no federal estate or GST transfer taxes imposed on the estate of any individual who dies in 2010. Meanwhile, the estate and GST transfer taxes are “phased out” by increasing exemptions and declining maximum rates. But, the gift tax will continue in effect even after the repeal of the estate and GST transfer taxes.
2. Beginning January 1, 2001, the exemptions increased and the maximum tax rates declined. As of 2004, the GST exemption equals the applicable exclusion amount or the unified credit exemption equivalent.
3. The gift tax remains in place, even after 2009 to deter income tax avoidance schemes.
4. The gift tax exemption increased to \$1 million in 2002 and will remain at that amount, even after the repeal of the estate and GST tax. After 2003, the amount that can be left to beneficiaries tax-free at death will be larger than the amount that could be given away tax-free during life. This is the first time this has happened since the adoption of the unified transfer tax system by the Tax Reform Act of 1976.
5. The maximum gift tax rate declined, along with the maximum estate tax rate, through 2009. In 2010, the maximum gift tax rate will be 35 percent, which is the same as the maximum individual income tax rate at that time under the 2001 Act.
6. Presumably, the Senate proposed retaining the gift tax (and the House eventually agreed) to help preserve the income tax base. Several commentators alerted the Senate to the possible techniques that could be used to minimize income taxes in a system with no gift tax, and the resulting damage to federal revenues. .
7. The amount of the state death tax credit was reduced significantly for taxpayers dying after 2001 and before 2005. Beginning in 2005, the credit will be eliminated and replaced by a federal estate tax deduction for amounts paid in state death tax.

**TABLE 1
EXEMPTIONS, TAX RATES AND CREDITS**

Year	Estate and GST Exemption at Death	Gift Tax Exemption	Highest Estate, Gift and GST Tax Rate	State Death Tax Credit Reduction from Current Amounts
2002	\$1,000,000	\$1,000,000	50%	-- 25%
2003	\$1,000,000	\$1,000,000	49%	-- 50%
2004	\$1,500,000	\$1,000,000	48%	-- 75%
2005	\$1,500,000	\$1,000,000	47%	Deduction Replaces Credit
2006	\$2,000,000	\$1,000,000	46%	
2007	\$2,000,000	\$1,000,000	45%	
2008	\$2,000,000	\$1,000,000	45%	
2009	\$3,500,000	\$1,000,000	45%	
2010	Taxes repealed	\$1,000,000	0%	N/A

**TABLE 2
RATE BRACKETS AND MARGINAL TAX RATES**

For Taxable Estates Exceeding	Marginal Rates for 2001	Marginal Rates for 2002	Marginal Rates for 2003	Marginal Rates for 2004	Marginal Rates for 2005	Marginal Rates for 2006	Marginal Rates for 2007
\$675,000	37%	0%	0%	0%	0%	0%	0%
\$750,000	39%						
\$1,000,000	41%	41%	41%	45%	45%	46%	45%
\$1,250,000	43%	43%	43%				
\$1,500,000	45%	45%	45%				
\$2,000,000	49%	49%	49%	48%	47%	46%	45%
\$2,500,000	53%	50%					
\$3,000,000	55%						

III. Economic Analysis Relating to Estate And Gift Taxation

A. Estates Subject to the Estate Tax.

1. The percentage of decedents liable for the estate tax reached a peak in the mid-1970s. In 1977, 7.65 percent of all estates were subject to the Federal estate tax. Because of the substantial revisions to the estate tax in 1976 and subsequent further modifications in 1981, the percentage of decedents liable for the estate tax was significantly reduced. In 1988 and 1989 less than 1 percent of the estates of all decedents were subject to the Federal estate tax.

2. Because of the failure of the unified credit to keep pace with the increase in wealth, the percentage of estates subject to the Federal estate tax has continued to increase since 1990. According to the Joint Committee study, the increasing percentage of decedents liable for estate taxes are the result of the interaction of three factors: a fixed nominal exemption; the effect of price inflation on asset values; and real economic growth.

B. Who Pays the Estate Tax?

1. The minimum filing requirement was \$625,000 for individuals who died in 1997 (the amount is \$1,500,000 in 2004). In 1997, there were 43,000 decedents whose estates incurred estate tax. This represents 1.85 percent of all deaths.
2. Estates over \$5 million accounted for 5.4 percent of taxable estates, but paid about one-half of the total estate taxes paid in 1997. Taxable estates over \$20 million accounted for less than one percent of all estate tax returns, but more than 25 percent of the total asset value.

C. Revenues from the Estate, Gift and Generation-Skipping Taxes.

1. During the 1980s, the revenues from the estate, gift, and generation-skipping taxes was generally less than 1 percent of the total of all Federal receipts. During the 1990s, the estate and gift tax receipts averaged double-digit rates of growth reaching a high in 1999 of 1.52 percent of total federal receipts.
2. According to the Joint Committee study, this growth occurred for several reasons. First, the increase in the number of persons that were subject to the estate and gift tax system. Second, the increase in value of the stock market increased the number of estates that became taxable. For example, the Dow Jones Industrial average ended in 1993 at approximately 3,750 and ended in 1999 at approximately 11,000. Also, the unlimited marital deduction enacted in 1981 delayed the payment of estate taxes until the surviving spouse's death. Because females outlive males by approximately 10 years, an increase in estate tax receipts was expected as a result of the first spouse's death during the 1980s that took advantage of the unlimited marital deduction.
3. The Joint Committee on Taxation has prepared an estimate of revenues from the estate, gift, and generation-skipping taxes for the fiscal years 2000-2011. According to that study, the percent of decedents subject to estate tax will increase from 2.18 percent in

2000 to 2.52 percent in 2011. The receipts from the estate tax will increase from \$29 billion in 2000 to \$53.4 billion in 2011.

D. Comparison of Transfer Taxation in the United States and Other Countries

1. More developed countries utilize an inheritance tax rather than the estate tax that is imposed in the United States. An inheritance tax is imposed upon the amount of the wealth the transferee or donee receives rather than the total wealth of the transferor. Countries that impose an inheritance tax do not have a generation-skipping tax but impose a higher rate of inheritance tax on bequests that skip generations.
2. Australia and Canada impose neither an estate tax nor an inheritance tax. Canada repealed its death tax in 1971, but replaced the tax with a 23 percent tax on one-half of the capital gains on property transferred on death.
3. According to the Joint Committee on Taxation study, it is difficult to compare the U. S. estate tax to those countries with inheritance taxes because the applicable marginal tax rate depends on how the individual disposes of the property.
4. The highest marginal rate in Japan are 70 percent and in France the highest marginal rate is 60 percent. The marginal rates in both of these countries are higher than the 48 percent highest marginal rate in the United States.
5. The valuation of assets in the United States is based on fair market value and in other countries it is not always the case. For example, Japan taxes real estate at its assessed value which may be less than its fair market value. Also, it is not clear to what extent transferors may be able to exploit legal loopholes in other countries. For example, before 1988 in Japan a transferor could reduce inheritance tax liability by adopting children to increase the number of legal heirs. This legal loophole was said to be widely used by many wealthy families.
6. Belgium, France, and Japan collect more revenue from inheritance as a percentage of gross domestic product than does the United States.
7. Most developed countries collect substantially less revenue from inheritance or estate taxes as a percentage of gross domestic product than does the United States.

E. Considerations Favoring Repeal of the Estate Tax

1. The estate tax is a tax on property that an individual has saved during the individual's lifetime. By taxing savings, the estate tax creates disincentives for individuals to save. The estate tax punishes the most successful economic producers by subjecting them to high marginal tax rates.
2. With a maximum income tax rate of 35 percent and maximum estate tax rate of 48 percent, the combined marginal rate can be viewed as 68.8 percent. This rate structure produces a confiscatory system that destroys productivity. (Because appreciation on assets during lifetime is not subject to income tax, the argument that the estate tax is double taxation on savings is not accurate.)
3. The estate tax is imposed on assets includable in the decedent's estate, which often depends on the analysis of interests and powers for which there are no bright lines. The estate tax is imposed on the fair market value of assets, and some assets have no market and are difficult to value. The subjective elements of valuation often produce widely inconsistent results from one case to another.
4. Avoiding estate tax generally involves complex legal structures and significant expense. Incurring these costs are essentially wasteful because time, effort, and financial resources are spent that lead to no increase in national wealth. The estate tax fosters aggressive and often artificial avoidance planning that is not only expensive but reduces the equity of the tax. Many avoidance devices serve no family planning purposes other than estate tax avoidance.
5. Most family businesses are very illiquid. Because the estate tax must be paid in cash within nine months following the owner's death, opponents of the estate tax claim that many family businesses do not survive due to the estate tax. Although there is relief provisions for family businesses under present law, these provisions are extremely complex and cumbersome.

F. Considerations Supporting the Retention of the Estate Tax

1. Some proponents of the estate tax argue that in addition to producing revenue, estate taxes may help prevent an increase in the concentration of wealth. These proponents state that concentrations of wealth are economically wasteful or socially unhealthy.

2. The income tax does not tax all sources of income. The estate tax serves as a backstop for income that escapes income taxation. Thus, the estate tax system may help promote overall fairness of the U. S. tax system.
3. If Congress repealed the estate tax system, Congress would have to replace the present income tax system with carryover basis. Otherwise, post acquisition appreciation would not be taxed. Carryover basis has significant administrative problems.
4. Because the top marginal estate tax rate is 48 percent in 2004, it costs an individual significantly less to make a charitable bequest at death. There have been a limited number of studies examining the effects of estate taxes on charitable bequests. Most of these studies conclude that deductibility of charitable bequests encourages tax payers to provide charitable bequests.
5. William H. Gates, Sr., David Rockefeller, Jr., George Soros, Paul Newman, and others formed a loosely organized group to support the estate tax. According to this group, repeal would “enrich the heirs of America’s millionaires and billionaires while hurting families who struggle to make ends meet.” The group went on to state that lost tax revenue would be made up by increasing taxes on those less able to pay or by cutting social programs.

G. Congressional Options

1. Congress has the option of making permanent the 2010 repeal of the estate and generation-skipping tax. Total repeal would be expensive because of the revenue costs.
2. One option is for Congress to replace the existing estate and gift tax system with another system, such as taxing capital gains at death, an accessions tax, or income inclusion tax. .
3. One option to repealing the estate and gift tax system is for Congress to increase the exemption from the present \$1,500,000 to \$3,000,000. By doing this, Congress would be eliminating approximately 95 percent of those presently subject to estate tax but would eliminate only half of the total estate taxes paid.
4. Congress could also lower the top rate from the present 48 percent to a rate closer to the top income or capital gains tax marginal rate. Lowering the top estate tax rate to a rate closer to the top income tax rates would support the position that the estate tax is a backstop to the income tax.

IV. Reform: The Task Force on Federal Transfer Taxes

A. Organization of Task Force

1. The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) enacted by Congress in 2001 phases out over nine years the estate and generation-skipping transfer taxes, repeals for one-year the estate and GST taxes in 2010 (while leaving the gift tax in place), and reinstates the estate and GST taxes in 2011. The provisions of EGTRRA create significant uncertainty for clients in estate and financial planning matters.
2. The leadership of several organizations interested in transfer taxes believed that the public would benefit if a group of individuals knowledgeable in the tax law studied and prepared a report on the estate, gift, and generation-skipping transfer tax system. Accordingly, these individuals encouraged their organizations to create the Task Force on Federal Transfer Taxes.
3. In 2001 the Task Force was formally organized as a multi-organizational group comprised of representatives from the American College of Trust and Estate Counsel, the American Bar Association's Section of Real Property, Probate and Trust Law, the American Bar Association's Section of Taxation, the AICPA, the American College of Tax Counsel, and the American Banker's Association.
4. There are more than 25 individuals participating as members of the Task Force. The Task Force has had more than 15 meetings during the last two years and is nearing the completion of its report. This outline is a review of some of the issues being addressed by the Task Force.

B. Purpose of Task Force

1. The purpose of the Task Force is to prepare a comprehensive report for submission to Congress, the Treasury, and the public which analyzes technical and transitional consequences of the significant changes enacted in 2001 with respect to the gift, estate and generation-skipping transfer taxes, and various alternative legislative measures that might be adopted to eliminate the substantial uncertainties that taxpayers and their advisers now face under the existing transfer tax system.

2. The Task Force Report discusses issues arising under:
 - a. present law (a long phase-out, a one-year repeal, and reverting to prior law),
 - b. carryover basis,
 - c. the retention of the gift tax system,
 - d. the existing federal estate, gift and generation-skipping transfer (“GST”) tax system, and
 - e. alternatives to a transfer tax system.
3. University of Minnesota Law Professor Mary Louise Fellows is the reporter for the project and is the primary draftsman of the Report. The Task Force has received grants from the ACTEC Foundation as well as the American Tax Policy Institute.
4. The Task Force has submitted its Report to the ACTEC Board of Regents, the Board of Governors of the American Bar Association, and the governing bodies of the other constituent organizations for review and approval. The Task Force intends to have its Report available to our members and the public when it is finished. In addition, members of the Task Force plan to make presentations about the Report to various interested groups.

C. Organization of Report.

1. The Task Force Report will not consider policy questions having to do with the economic effects of a transfer tax system as compared to other forms of taxation. The Report also will not consider policy questions having to do with whether redistribution of wealth is an appropriate goal of a tax system. The central concern of the Report is to assess, on the basis of simplicity, compliance, and consistency of enforcement, the temporary repeal of the estate and generation-skipping transfer taxes, the phase-out period, the continuation of the gift tax after repeal, the modified carry-over basis rule, and the alternatives to transfer tax repeal.
2. With most issues the Report identifies, the Report suggests options that Congress might consider, but the Report does not make specific recommendations for regulatory or legislative action. The Report appreciates that Congress could decide that its best course of action is to leave current law in place and, therefore, the Report does not separately identify the option of retaining current law in any of its lists of alternatives but that is implicit. The Task Force members and sponsoring organizations support the analysis of

alternative solutions to the issues identified, but do not endorse any specific solution.

3. The Report has four parts and an appendix. Part I considers issues that pertain to the phase-out period of the estate and GST taxes and their reinstatement in 2011. Part II addresses issues arising from Congress's retention of the gift tax for the purpose of protecting the integrity of the income tax system upon reduction and ultimate repeal of the estate and GST taxes. Part III discusses the issues arising upon implementation of the modified carry-over basis rule that takes effect upon repeal of the estate and GST taxes.
4. Part IV and the Appendix shifts attention away from EGTRRA and consider alternatives to repeal of the estate and GST tax systems. Part IV identifies issues arising under the current estate, gift, and GST tax law and suggests alternative ways of resolving those issues within a wealth transfer tax system. As part of its discussion, Part IV reviews alternative approaches that Congress may want to adopt during the phase-out of the estate and GST taxes. The Appendix evaluates alternatives to the current wealth transfer tax law and to the repeal of the estate and GST tax laws accompanied by a modified carryover-basis rule.

V. The Phase Out of the Estate and GST Taxes and Their Subsequent Reinstatement

A. Inadequate Estate Plans

1. Issue: The complexities of estate planning, especially in view of the changing tax law, may be a reason for Congress to expand its recognition of state-authorized reformation of wills and other governing instruments.
2. Alternative: Recognize a State Law Doctrine of Reformation
 - a. Congress could recognize reformations of wills and other governing instruments that a state court makes to conform the terms of an instrument to a transferor's intention, which would include consideration of a transferor's tax objectives. If a state permits reformation by agreement of the parties without the need to obtain a court-ordered modification, Congress could recognize that procedure also upon a showing that the reformation furthered a transferor's intent.
 - b. What this alternative would acknowledge is that the doctrine of reformation, especially in view of the scheduled changes in tax law, can operate in a manner that respects

and furthers the integrity of the law and does not lead to artifice by planners.

3. Alternative: Authorize a Qualified Transfer Made in Furtherance of a Transferor's Intent.
 - a. Congress could permit recipients to make transfers of the interests they have received from decedents as if they were acting under a durable power of attorney or a power of appointment. The advantage of this alternative is that it provides flexibility and avoids the administrative costs of having to obtain court approval. Congressional authorization of what might be called a "super disclaimer" rule or "a qualified transfer" would permit adjustment of an estate plan to conform to a decedent's donative intent without the qualified transferor incurring federal gift tax liability.
 - b. A qualified transfer could operate either in conjunction with, or instead of, congressional recognition of court-approved reformations of governing instruments.

B. Planning under a Lengthy Phase-Out Period

1. Issue: The lengthy phase-out period of the estate and GST taxes causes complexities and uncertainties as taxpayers engage in financial and estate planning. EGTRRA's treatment of gift taxes and GST taxes during the phase-out period further exacerbates a taxpayer's planning difficulties.
2. Alternative: Reduce the Length of the Phase-Out Period. If Congress makes repeal of the estate and GST taxes permanent, Congress could reduce the length of the phase-out period and thereby reduce planning complexity.
3. Alternative: Reunify the Estate and Gift Taxes during the Phase-Out Period and Repeal the GST Tax Immediately.
 - a. If Congress makes repeal of the estate and GST taxes permanent, Congress could reunify the estate and gift tax systems during the phase-out period and repeal the GST tax immediately. Immediate repeal of the GST tax would have minimal revenue effect, because, in most situations, taxpayers are not going to find it difficult to defer imposition of the GST tax until the end of the phase-out period.

- b. Congress could reunify the estate and gift taxes during the phase-out period and immediately repeal the GST tax whether or not Congress decides to reduce the length of the phase out of the estate tax.
- 4. Alternative: Repeal the Gift Tax. If Congress makes repeal of the estate and GST taxes permanent, Congress could repeal the gift tax along with the GST and estate taxes. This alternative is unrelated to the length of the phase-out period.
- 5. Alternative: Modify the Estate, Gift, and GST Taxes. If Congress decides not to repeal the estate and GST taxes, Congress could, instead, modify the estate, gift, and GST taxes that are currently in place. The Report considers what those modifications might be.
- 6. Alternative: Adopt a Taxing System Other Than a Wealth Transfer Tax System.
 - a. If Congress decides to make repeal of the current wealth transfer tax system permanent, including the gift tax, Congress could replace the present transfer tax system with: (1) an accretion tax; (2) an income-inclusion system, in which transferees would include in their gross income the value of property that transferors donatively transfer to them either during life or at death; or (3) a deemed-realization system, in which the law would treat donative transfers as realization events for income tax purposes.
 - b. The Report addresses alternative taxing systems in the Appendix.

C. State Death Tax Credit

- 1. EGTRRA reduces, and then eliminates, the federal credit for state death taxes over a period of four years. In 2002, the credit was reduced by 25 percent of its historical amount; and in 2003, by 50 percent of its historical amount. In 2004, the credit is reduced by 75 percent of its historical amount. and in 2005, the credit is eliminated altogether and is replaced with a general deduction for amounts paid for state estate and inheritance taxes. The deduction continues until the federal estate tax is repealed in 2010. In response to these changes, more than fifteen states have “decoupled” their state death taxes from the federal credit for state death taxes.
- 2. Issue: EGTRRA’s phase out and repeal of the state death tax credit, accompanied by the introduction of a deduction for state death taxes, create planning complexities and uncertainties.

3. Alternative: Recognize a State Law's Doctrine of Reformation. Congress could view the compliance and planning difficulties arising from the phasing out of the state death tax credit and the substitution of a deduction for state death taxes as an added reason for Congress to recognize state-authorized reformation to a decedent's governing instruments.
4. Alternative: Reduce the Length of the Phase-Out Period. Congress could view the compliance and planning difficulties arising from the phasing out of the state death tax credit and the substitution of a deduction for state death taxes as an added reason, if Congress decides to make the repeal of the estate and GST taxes permanent, for Congress to reduce the length of the phase-out period.
5. Alternative: Restore the State Death Tax Credit. If Congress decides not to make repeal of the estate and GST taxes permanent, Congress could restore the state death tax credit as it applied before EGTRRA changes.

D. Temporary Repeal

1. Issue: The one-year repeal of the estate tax and the introduction of the modified carryover basis rule create uncertainties, inequities, complexities, and planning difficulties.
2. Alternative: Either Promptly Make the Repeal Permanent or Promptly Reinstate the Estate Tax. Congress could promptly make the repeal permanent or promptly reinstate the estate tax. In either case, Congress would alleviate the uncertainties and inequities created by a one-year repeal of the estate tax accompanied by the introduction of a modified carryover basis rule. An extension of the period of repeal without making it permanent would not substantially improve the uncertain tax climate.
3. Alternative: Allow Estates of Decedent's Dying in 2010 to Elect to Be Subject to the Estate Tax Law in Effect in 2009.
 - a. If the repeal remains in place for one year, Congress could allow personal representatives of the estates of decedents who die in 2010 to elect whether the personal representative wants the estate to be subject to the law in place as of 2009, rather than the law in place for the year 2010. Congress could provide that the election, once made, is irrevocable.
 - b. The advantage of an election is that it would ameliorate the disparate treatment that arises merely because a decedent happens to die in 2010, rather than 2009. The election

alternative also ameliorates the record-keeping problems created by the modified carryover basis rule. The election alternative does not address the disparate tax treatment, however, that arises by the fact that a decedent dies in 2009, rather than in 2010, or dies in 2011, rather than in 2010.

E. Repeal of the Generation Skipping Transfer Tax

1. Issue: Temporary repeal and reinstatement of the GST tax create unique transition problems, because trusts can span the years when the tax is phased out, repealed, and reinstated.
2. Alternative: Enact Clarifying Transition Rules.
 - a. If repeal is not to be permanent, Congress could enact transition rules to clarify how to apply the GST tax to trusts that span the years when the tax is phased out, repealed, and reinstated. Congress could provide that the GST tax will not apply to any trusts or portions of trusts that transferors fund in 2010 either by lifetime or deathtime transfers. The effect of this rule would be to treat dispositions made in trust the same as outright dispositions during 2010 when the GST tax is not in effect.
 - b. Alternatively, Congress could allow transferors who make lifetime gifts in trust in 2010 to allocate GST exemption to the trusts in 2010. An allocation of the exemption would not seem to be necessary for deathtime transfers to trusts because the absence of a “transferor” as defined under the GST tax presumably precludes imposing the GST tax to such trusts. Congress could clarify whether the GST tax applies to deathtime transfers in trust by decedents dying in 2010. If Congress modifies the definition of a “transferor” to allow the GST tax to apply to trusts funded at the death of a decedent, then Congress could allow the estate to allocate GST exemption to the trust in 2010.
 - c. Congress could clarify what the effect is on the identity of the transferor of a GST in 2010 when property after the GST is in trust for younger generations, and the GST tax is later reinstated.
3. Alternative: Make the Technical Provisions Permanent.
 - a. Congress could make the technical provisions of EGTRRA, which Congress intended to help taxpayers avoid inadvertent imposition of the GST tax, permanent.

- b. These technical provisions are not controversial and have no significant revenue impact. In the absence of congressional action, these technical provisions will sunset in 2011 along with the rest of EGTRRA.

VI. The Gift Tax

A. Domestic Transfers

1. Issue: EGTRRA's treatment of the gift tax is not a well-tailored solution for addressing the potential income tax abuse from transfers between U.S. taxpayers. In addition, the retention of the gift tax creates enforceability problems, encourages gift tax avoidance strategies, and interferes with non-tax estate planning goals.
2. The Task Force's alternatives have three common goals. The first is to develop approaches that maximize ease of enforcement and administrability. The problems raised concerning enforcement and administrability of a gift tax system in the absence of estate and GST taxes prompt the development of alternatives that rely on the income tax to address the income tax avoidance issues that lifetime transfers between U.S. taxpayers potentially generate. The second goal is to present alternatives that minimize interference with intra-family transfers of wealth and maximize the orderliness of intergenerational wealth succession. This objective is consistent with the underlying rationale for Congress's repeal of the estate and GST taxes. The third goal, which is integrally related to the first two goals, is to tailor the alternatives carefully to the specific potential abuses.

B. Alternatives to the Retention of the Gift Tax

1. Alternative: Repeal the Gift Tax and Issue Regulations on Agency Relationships between U.S. Transferors and Transferees.
 - a. Congress could repeal the gift tax and mandate Treasury to issue regulations that treat a U.S. transferor as the continuing owner of an asset, if the U.S. transferee has implicitly or explicitly agreed to return the asset, either directly or indirectly, to the transferor.
 - b. The income tax compliance rules seem to be sufficiently robust to target and prevent a transfer that does nothing more than "park" assets with a transferee, who has a more advantageous tax position than the transferor. This is true whether the expectation of transferors is that their transferees will return the asset directly back to them or is

that the transferees will indirectly benefit their transferors by their giving the property to persons the transferors want to benefit.

2. Alternative: Repeal the Gift Tax and Treat Gifts as a Realization Event, Unless the Donor Elects to Be Treated as the Continuing Owner. Congress could repeal the gift tax and treat the gift as a realization event, unless the donor elects to continue to be treated as the owner of the property for all income tax purposes.
3. Alternative: Repeal the Gift Tax and Tax a Donee's Disposition of an Asset Acquired by Gift at the Highest Applicable Tax Rate.
 - a. Congress could repeal the gift tax and enact a provision that taxes the sale or other disposition of an asset that a taxpayer receives as a gift at the highest applicable tax rate, if the taxpayer sells or disposes of the asset within a stated time period after having received the asset.
 - b. Congress further could provide that the character of the asset stays the same as it was while held by the donor. Congress could go even further and deny donees the right to offset capital gains from the sale or disposition of assets they receive by gift against capital losses from the disposition of their other assets.
4. Alternative: Retain the Gift Tax Accompanied by a Grantor Trust Election.
 - a. Congress could retain the gift tax, but allow a donor to avoid the gift tax, if the donor elects grantor trust treatment.
 - b. This proposal is an expansion of the approach Congress adopted under EGTRRA in which it provided in IRC § 2511(c) that, effective after 2009, transfers in trust are taxable as gifts, unless the trust is treated as wholly owned by the donor or the donor's spouse for income tax purposes.
5. Alternative: Retain the Gift Tax with Modifications to the Annual Exclusion and Valuation Rules. Congress could adopt a rule that denies an annual exclusion in those instances where the transfer is solely for the purpose of income tax avoidance.

VII. Modified Carryover Basis Rules Enacted by EGTRRA

A. General Rules

1. Issue: A comparison of the differences in how basis is determined in property acquired from a decedent before and after repeal of the estate tax reveals significant changes in estate planning strategies, especially with regard to planning for closely-held businesses, as well as some opportunities for simplification.

B. Alternatives

1. Alternative: Treat Unrecognized Losses Consistently.
 - a. Congress could amend IRC § 1022 to provide that a recipient takes a carryover basis in the property, except that, if the fair market value is less than basis at the time of decedent's death, then for purposes of determining loss upon a subsequent sale or exchange, the recipient's basis is the asset's fair market value at decedent's death. This rule would correspond to IRC § 1015.
 - b. Alternatively, Congress could amend IRC § 1015 to correspond to IRC § 1022 and require a donee to take a basis equal to the lesser of the donor's basis or the asset's fair market value at the time of the gift.
 - c. Yet a third approach is for Congress to adopt a strict carryover basis rule for both lifetime and deathtime transfers of assets that have depreciated in the hands of the transferor. All three approaches would eliminate the differential treatment between lifetime and deathtime transfers with regard to property that has a fair market value less than the transferor's basis at the time of transfer.
 - d. In any case, Congress could amend IRC § 1223 to attribute the transferor's holding period to the recipient, even if IRC §§ 1015 and 1022 require the recipient to take a basis equal to the asset's fair market value at the time of the transfer.
2. Alternative: Retain IRC § 1014 for Tangible Personal Property Not Held for Investment or Used in a Trade or Business.
 - a. Congress could provide an IRC § 1014-type allowance, in addition to a smaller allowance for basis increases based on unrealized appreciation, for tangible personal property not held for investment or used in a trade or business.

5. Alternative: Allow a Personal Representative to Elect to Adjust Basis for Estate Administration Expenses.
 - a. Congress could allow a personal representative to elect to treat all or a part of the estate's administration expenses as (i) a deduction in computing the taxable income of the estate (or trust) or (ii) an adjustment to basis in accordance with the applicable rules under IRC § 1022.
 - b. This proposal would prevent estate administrative expenses from remaining unused, because the estate had insufficient income to offset these otherwise deductible expenses.

C. Property Subject to Debt

1. Issue: IRC § 1022(g) creates opportunities for tax avoidance at the same time that it creates potential unfairness for a recipient, who may have a tax liability in excess of the equity in the property acquired from the decedent.
2. Alternative: Establish a Right of Recovery from Recipients of a Decedent's Property.
 - a. Congress could establish a right of a recipient of encumbered property to recover from the other recipients of a decedent's assets the income tax liability attributable to the difference between the amount of encumbrance and the carryover basis of the encumbered property to the extent that income tax liability exceeds the recipient's equity in the asset at the time of sale or other disposition. It could determine the amount recoverable from each recipient based on the proportionate value of the assets each has received or another equitable method.
 - b. Congress could also allow an executor to elect to avoid the right-of-recovery rule by recognizing gain on an encumbered asset based on the difference between the amount of debt and the modified carryover basis. The executor's election would result in an income tax liability payable from the assets in the decedent's estate.
3. Alternative: Treat the Transfer of Property Encumbered with Debt in Excess of Its Adjusted Basis at a Decedent's Death as a Realization Event. Congress could treat the transfer at death of property encumbered with debt in excess of its adjusted basis as a realization event to the extent of the amount of debt.

4. Alternative: Forgive the Income Tax Liability Through a Basis Adjustment. Congress could increase the basis of an encumbered asset by an adjustment equal to the difference between the decedent's carryover basis in the property and the amount of the encumbrances on the property whenever the amount of debt exceeds that basis. Congress could reduce the aggregate basis increase of \$1.3 million, which IRC § 1022(b)(2)(B) allows, but not below zero, by any adjustment of the basis of the encumbered property.
5. Alternative: Permit a Recipient of Property Encumbered with Debt in Excess of Its Adjusted Basis to Elect an Excise Tax. Congress could allow a recipient of property encumbered with debt in excess of its adjusted basis to elect an excise tax accompanied by a step-up in basis rule similar to that found in IRC § 1014. It could determine the recipient's excise tax liability by applying a flat tax rate against the asset's fair market value reduced by its associated indebtedness.
6. Alternative: Treat the Transfer of Encumbered Property at Death as a Nonrealization Event Only for Encumbrances not Acquired for Income Tax Avoidance Purposes, and Limit a Recipient's Tax Liability on Encumbered Property to the Amount of Equity. Congress could treat a transfer of encumbered property by a decedent to a recipient as a realization event to the extent of the amount of debt, unless the estate demonstrates that the decedent had not obtained the loan and secured it with the property for tax avoidance purposes.
7. Alternative: Treat the Segregation of Property Encumbered with Debt in Excess of Its Adjusted Basis as a Realization Event. Congress could treat as a realization event the segregation of property encumbered with debt in excess of its adjusted basis in a manner that insulates the decedent's and the recipient's wealth from having to satisfy the income tax liability generated by the encumbrance.

D. Income in Respect of a Decedent (IRD)

1. Qualified Retirement Plans and IRAs
 - a. Issue: The distinction that IRC § 1022 makes between a decedent's appreciated assets held in qualified retirement plan and IRA accounts and a decedent's other appreciated assets held outside of these types of accounts could be viewed as unfair.

b. Alternatives

- (1) Allow Basis Increases to the Extent of the Growth of the Assets Contributed to Qualified Retirement Plans and IRAs. Congress could allow an executor to allocate basis increases authorized by IRC § 1022 to assets held in qualified retirement plans and IRAs, but only to the extent of the growth in the accounts.
- (2) Allow Basis Increases at an Accelerated Rate for Assets Held in Qualified Retirement Plans and IRAs. Congress could allow an executor to allocate basis increases at an accelerated rate to assets held in qualified retirement plans and IRAs. The accelerated rate would take into account the difference between the tax rates on ordinary income and on capital gains.
- (3) Allow Basis Increases for Assets Held in Qualified Retirement Plans and IRAs Only if the Executor Cannot Make Allocations to Other Assets. Congress could allow an executor to allocate basis increases to assets held in qualified retirement plans and IRAs, but only that amount of the available basis increases that the executor could not have allocated to assets not held in qualified plans and IRAs.

2. Installment Sales

a. Issue: The ineligibility of installment sale contracts or promissory notes for any basis increases under IRC § 1022 could be viewed as unfair.

b. Alternatives

- (1) Allow Basis Increases to the Extent of Appreciation of the Installment Obligation. Congress could permit an executor to allocate basis increases to a promissory note received in exchange for property to the extent that the note's value has appreciated.

- (2) Allow Basis Increases to an Installment Obligation to the Extent It Represents Unrecognized Gain. Congress could allow an executor to allocate basis increases to a promissory note received in exchange for property to the extent the note represents unrecognized gain.

E. State Death Taxes

1. Issue: Neither IRC § 691 nor § 1022 provides an adjustment to basis for state death taxes paid on items of IRD.
2. Alternative: Permit a Deduction under IRC § 691 for State Death Taxes Attributable to an Item of IRD.
 - a. If, as is likely, states continue to impose state death taxes after the repeal of the estate tax, Congress could amend IRC § 691(c), which has to do exclusively with the federal estate tax, and allow an income tax deduction for state death taxes attributable to an item of IRD.
 - b. The effect of the deduction would be to ameliorate the double tax on an item of IRD that is subject to both the federal income tax and state death taxes.
3. Alternative: Permit an Adjustment to Basis under IRC § 1022 for State Death Taxes Attributable to an Item of IRD. Congress could amend IRC § 1022 and allow an increase in the basis of an item of IRD for state death taxes attributable to the item.

F. Unused Loss Carryovers and Built-in Losses

1. Issue: IRC § 1022(b)(2)(C)'s basis adjustments for net operating losses and capital loss carryovers under IRC § 1022(b)(2)(C) raise the question of whether this relief provision includes or should include other loss carryover rules, having to do with pass-through business entities and at-risk and passive activity rules.
2. Alternatives: In their consideration of extending the basis increase rules found in IRC § 1022(b)(2)(C), Congress or Treasury may want to take account of the fact that the suspended losses under IRC §§ 465, 469, 704(d), and 1366(d) are asset specific. In contrast, a decedent may have derived an aggregate net operating loss or capital loss carryovers from a number of sources and after application of various limitations and mechanical rules. Moreover, a taxpayer's loss carryovers are available to absorb income from a

variety of sources unrelated to the particular asset or activity that produced the carryover. In contrast, suspended losses under either the basis (IRC §§ 704(d), 1366(d)), at-risk (IRC § 465), or passive activity loss (IRC § 469) rules are asset specific, except when taxpayers completely dispose or terminate their interests in the activity. In this regard, the alternatives consider the possibility of Congress or Treasury providing for increases to basis for suspended losses, but limiting those increases to those assets of the decedent that were the source of the losses.

G. Aggregate Spousal Property Basis Increase

1. Qualified Spousal Property

- a.** IRC § 1022(c) provides a basis increase in addition to the aggregate basis increase provided for under IRC § 1022(b) of up to \$3 million for appreciated property passing from decedents to their surviving spouses. Under the law before and after 2010, property passing to a surviving spouse that qualifies for the marital deduction ("marital deduction property") receives a step-up in basis equal to its fair market value determined at the date of death of the first spouse, even though it is not subject to estate tax at the death of the first spouse. The \$3 million additional basis increase for property acquired by a surviving spouse ("aggregate spousal property basis increase") is meant to approximate this result, albeit to a limited extent.
- b.** The \$3 million aggregate spousal property basis increase is available for "qualified spousal property," which IRC § 1022(c)(3) defines as (i) property passing outright to a surviving spouse and (ii) QTIP. IRC § 1022(c)(4), which is a provision akin to IRC § 2056, defines "outright transfer property" as an interest in property, other than certain types of terminable interest property, acquired from a decedent by a surviving spouse. IRC § 1022(c)(4)(B) uses a definition of nonqualifying terminable interest property that is the equivalent of the definition of a nondeductible terminable interest set forth in IRC § 2056(b)(1).

2. Issue: The statutory language is unclear as to whether estate trusts qualify for the aggregate spousal property basis increase.
3. Issue: The statutory language of IRC § 1022(c)(5)(B) is uncertain and may be too restrictive regarding the requirements of a qualifying income interest for life.

4. Issue: IRC § 1022 permits basis increases for property that surviving spouses own outright at their deaths, but it denies basis increases at the death of surviving spouses for QTIPs or for property subject to general powers of appointment.
5. Issue: The exception of spousal transfers from the general rule that property acquired by gift within three years of a decedent's death is not eligible for basis increases provides spouses more favorable treatment than would be available if IRC § 1014(e) were to apply.
6. Issue: The statute does not acknowledge that decedent's directives regarding allocation are controlling and, even if it did, the statute's approach to basis modifications creates difficult drafting issues that can lead to complexities, uncertainties, and litigation.
7. Issue: The statute does not allocate basis increases, if the personal representative fails to do so.
8. Issue: The modified carryover basis rule raises new compliance and finality issues, which, in turn, may increase the instances of inconsistent reporting by the decedent's estate and the recipients of property acquired from the decedent.

VIII. The Wealth Transfer Tax System

A. The Annual Exclusion

1. Issue: The present interest requirement for annual exclusion gifts, particularly for gifts in trust, creates complexity and uncertainty.
2. Alternative: Retain the present interest requirement and deny the annual exclusion for gifts in trust.
3. Alternative: Retain the present interest requirement and allow the annual exclusion for gifts in trust that meet the GST tax requirements of IRC 2642(c).
4. Alternative: Impose additional or different types of dollar limitations.
5. Alternative: Expand the annual exclusion to cover transfers to parents and adult children who have insufficient income and assets to support themselves.

B. Portability of the Unified Credit and the GST Exemption Between Spouses

1. Issue: Many couples engage in sophisticated planning techniques and frequent reallocation of assets to assure that each spouse can take full advantage of the unified credit and GST exemption.
2. Alternative: Allow the surviving spouse a portable applicable exclusion amount at death.
3. Alternative: Allow the surviving spouse a portable applicable exclusion amount for transfers subject to the gift tax.
4. Alternative: Allow the surviving spouse portability of the GST exemption.
5. Alternative: Allow the surviving spouse portability of lower rate brackets.

C. Valuation of Interests in Entities and Unique Items of Tangible Property

1. Issue: The rules that have evolved for valuing interests in entities and unique items of tangible property are inconsistent, create uncertainty, and cause controversy.
2. Alternatives. The valuation of interests in entities and unique items of tangible property raises contentious issues during the phaseout period. After repeal, valuation questions would remain for the purpose of determining the gift tax, if Congress were to retain the gift tax to protect the income tax. Valuation questions also arise under the modified carryover basis rule of IRC § 1022, because it requires a determination of an interest's fair market value. Therefore, the alternatives set forth below are relevant whether or not Congress decides to retain the estate and GST taxes or any form of wealth transfer tax system.
 - a. Establish Presumptive Valuation Guidelines and Safe Harbors. Congress could establish presumptive valuation guidelines and safe harbors to reduce valuation uncertainty and the controversy that it produces.
 - b. Eliminate Nonbusiness Valuation Discounts. Congress could adopt a transfer tax rule that values interests in an entity that is not publicly traded at a proportional share of

the net asset value of the entity to the extent that the entity holds nonbusiness assets at the time of a donative transfer.

- c. Aggregate Family and Donatively Transferred Interests. Congress could require that the value for transfer tax purposes of an interest in property should be equal to that interest's pro rata share of all interests in the property that the transferor and certain other persons hold.
- d. Recapture Discounts for Lack of Control. Congress could continue to permit valuation discounts upon transfers of noncontrolling interests in family-controlled entities or other assets, but impose an additional tax (with appropriate basis adjustments) when the recipients sell their interests or when the family owners liquidate the entity.
- e. Treat Diminutions in Net Worth as Taxable Gifts. Congress could treat diminutions in net worth as taxable gifts.

D. Coordinate Estate and Gift Tax Valuation Rules.

- 1. Congress could change the estate tax valuation rules to conform to the current gift tax treatment.
- 2. If Congress decided to make this change, the estate tax valuation would be based upon the value of the property transferred to the beneficiary or heir and not based on the value of the gross estate.

E. Simplify and Strengthen IRC §§ 2701, 2703, and 2704

- 1. Congress could modify IRC § 2704 to provide that the tax law will disregard restrictions on liquidation or withdrawal, whether imposed by state law or by partnership or limited liability company agreements, unless the restrictions are comparable to those agreed to by persons dealing at arms' length.
- 2. Strengthening Chapter 14 may solve some valuation questions, but would shift the controversy to what is comparable in an arms' length setting.

F. Establish Procedures for Resolving Valuation Controversies

- 1. Congress could resolve much of the uncertainty facing taxpayers who want to make gifts of interests in closely held entities and unique tangible property by establishing procedures that would permit taxpayers to receive an advance ruling regarding the value of an item of property that they intend to give.

2. This approach is similar to the approach available with gifts of art work.

G. Valuation of Temporal Interests in Property

1. Issue: Although the actuarial tables provide administrative convenience for both taxpayers and the IRS, the actuarial tables are not accurate predictors of future investment performance of assets.
2. Alternatives. The difficulty of valuing temporal interests is an issue during the phaseout period. It also remains an issue after repeal for purposes of determining the gift tax, assuming that Congress retains the gift tax. Therefore, the alternatives set forth below are relevant regardless of whether Congress retains the estate and GST taxes.
 - a. Extend the Application of IRC § 2702 to All Donees. Congress could extend IRC § 2702 to all gifts, regardless of the donee's relationship to the donor.
 - b. Require a Minimum Value for the Remainder Interest in an Annuity Trust. Congress could require that the remainder interest have a specified minimum value, such as 10 percent.
 - c. Eliminate the Exception to IRC § 2702 for Personal Residence Trusts. Congress could eliminate the exception for personal residences from IRC § 2702. The exception in IRC § 2702 for gifts of interests in personal residences and joint purchases of personal residences makes it possible for taxpayers to transfer interests in their personal residences to family members at a reduced gift tax cost.

H. The Use of Replacement Cost for Valuation Purposes

1. Issue: The use of replacement cost can lead to disparate tax results for similarly situated taxpayers.
2. Alternatives
 - a. Amend Valuation Rules to Use Liquidation Values for All Estate Assets. Congress could amend the valuation rules to provide that all estate assets are to be valued based on what an estate would receive upon the sale of the assets, rather than their replacement costs.
 - b. Amend Valuation Rules to Use Liquidation Values for Tangible Personal Property. Congress could amend the

valuation rules to provide that tangible personal property is to be valued at the amount a seller could realize upon the sale of the property.

I. The Tax Inclusive Estate Tax and the Tax Exclusive Gift Tax

1. Issue: A discrepancy arises between the computation of the estate tax and the gift tax because the law computes the estate tax on the decedent's taxable estate, which includes the dollars the estate must use to pay the estate tax (a tax inclusive tax base), but the law computes the gift tax on the value of the property the donor transfers, which does not include the dollars the donor uses to pay the gift tax (tax exclusive tax base).
2. Alternatives.
 - a. Adopt a Tax Exclusive Tax Base for the Estate Tax. Congress could adopt a tax exclusive tax base for the estate tax by adjusting the estate tax rates to account for the tax exclusive tax base or by providing an algebraic computation similar to the one available for net gifts.
 - b. Adopt a Tax Inclusive Tax Base for the Gift Tax. Congress could adopt a tax inclusive tax base for the gift tax by adjusting the gift tax rates to account for the tax inclusive tax base or by providing an algebraic computation that includes the gift tax liability as part of the gift tax base.
 - c. Amend IRC § 2053. Congress could amend IRC § 2053 by deleting the language "or any estate succession, legacy, or inheritances taxes" from IRC § 2053(c)(1)(B) and conforming accordingly IRC § 2053(d), which has to do with permitting an executor to elect to deduct state and foreign death taxes for estate tax purposes.

J. The Deduction for Management Expenses Under IRC § 2053

1. Issue: The deduction for management expenses, as contrasted to transmission expenses, under IRC § 2053 benefits the recipients of a decedent's assets and not the decedent's estate, and creates an incentive for executors to prolong estate administration and to maximize deductible estate management expenses.
2. Alternative: Allow Estates, for Estate Tax Purposes, a Deduction Only for Transmission Expenses. Congress could amend IRC § 2053(a) to restrict the deduction for estate administration expenses to transmission expenses alone.

K. Credit for Tax on Property Previously Taxed

1. Issue: IRC § 2013, which provides relief for previously paid estate taxes, does not provide relief for gift or GST taxes and does not prevent property from being taxed more than once a generation, as is generally true under the GST tax.
2. Alternatives
 - a. Expand the Credit for Previously Taxed Property to Include Gift and GST Taxes. Congress could expand the availability of the previously taxed property credit so that the credit applies to gift and GST taxes and not just the estate tax. Congress could restrict any expansion of the previously taxed property credit to prevent its abuse.
 - b. Amend Regulations to Address Technical Problems. Treasury could amend Treas. Reg. §20.2013-4(a) to value a life estate in the recipient based on the number of years the recipient survived the transferor and not on the recipient's life expectancy as determined at the transferor's death.
 - c. Repeal the Previously Taxed Property Credit. Congress could repeal IRC § 2013 and not provide a credit for previously taxed property.
 - d. Repeal the Previously Taxed Property Credit, and Enact a Credit for Property Transferred to the Same Generation as, or an Older Generation than, the Transferor. Congress could repeal IRC § 2013 and, instead, allow a previously taxed property credit when a transferor transfers previously taxed property to a recipient who is in the same generation as, or an older generation than, the prior transferor, i.e., the person who transferred the property to the current transferor and paid a transfer tax on it.

L. Nontestamentary Transfers and the Gross Estate

1. Issue: The need for the so-called string provisions of IRC §§ 2036, 2037, and 2038 under a unified wealth transfer tax system may be questionable, because arguably all they do is prevent a taxpayer from making a completed lifetime gift to avoid estate tax on future appreciation.

2. Alternatives

- a. Change the Hard-to-Complete Rule to an Easy-to-Complete Rule. Congress could repeal the current string provisions that establish a hard-to-complete rule for estate tax and, instead, enact an easy-to-complete rule that would impose only a gift tax at the time of a lifetime transfer on the entire value of the property subject to the transfer, regardless of whether the taxpayer retained any interests in or powers over the property.
- b. Allow Taxpayers to Elect Either Gift Tax or Estate Tax Treatment on Transfers of Assets over Which They Retain Enjoyment or Control. If a taxpayer transfers an asset during life and retains enjoyment of or control over that asset, Congress could allow the taxpayer to choose: (1) to have the transfer treated as a taxable gift of the full value of the asset immediately and not have the asset included in the taxpayer's gross estate at death, or (2) to not have the transfer treated as a taxable gift at the time of the transfer and instead have the asset included in the taxpayer's gross estate at death.

M. Annuities and Life Insurance

- 1. Issue: The need for special rules regarding annuity and life insurance contracts under a unified wealth transfer tax system may be questionable, because these types of contracts are not different from any other investment assets, and the special rules seem only to prevent taxpayers from avoiding tax on future appreciation by their making completed lifetime gifts.

2. Alternatives

- a. Allow Taxpayers to Elect Either Gift Tax or Estate Tax Treatment upon the Designation of a Beneficiary under an Annuity Contract or Its Transfer. Congress could permit a taxpayer to elect to treat the designation of a beneficiary under an annuity contract as a taxable transfer subject to the gift tax.
- b. Allow Taxpayers to Elect to Treat Premium Payments as Taxable Transfers Subject to the Gift Tax or to Have the Proceeds of the Life Insurance Contract Subject to the Estate Tax at Their Death. Congress could permit taxpayers to elect gift tax treatment when they pay life insurance premiums.

N. Jointly Owned Property

1. Issue: The determination of the proper treatment of jointly owned property under a unified wealth transfer tax system is difficult because of widespread noncompliance with the gift tax rules.
2. Alternatives.
 - a. Repeal IRC § 2040(a) and Apply IRC § 2040(b) to All Jointly Owned Property. Congress could repeal the consideration-furnished rule of IRC § 2040(a) and instead apply the rule of IRC § 2040(b) to all jointly owned property.
 - b. Repeal IRC § 2040 and Treat 100 Percent of the Value of the Jointly Owned Property as a Taxable Transfer under the Gift Tax. Congress could repeal IRC § 2040 and regard a transferor as having made a gift to the extent the transferor provided any consideration to acquire, improve, or maintain jointly owned property.
 - c. Allow Taxpayers to Elect Gift Tax or Estate Tax Treatment on 100 Percent of the Value of Jointly Owned Property. Congress could allow a taxpayer who transfers a jointly owned interest to a donee to elect gift tax treatment on the entire value of the jointly owned property.
 - d. Retain IRC § 2040 and Treat 100 Percent of the Value of the Jointly Owned Property as a Taxable Transfer Under the Gift Tax. Congress could retain current law, which treats a transferor who provides more than one-half the consideration for jointly owned property as having made a taxable gift, and retain the consideration-furnished rule of IRC § 2040(a) as well.
 - e. Provide That the Creation of Joint Interests Is an Incomplete Transfer for Gift Tax Purposes. Congress could provide that a transferor who provides consideration for jointly owned property has not made a completed transfer for gift tax purposes. It could adopt a similar rule for subsequent improvements or contributions to the jointly owned property.

O. Payment of Estate Tax on Annuities

1. Issue: Annuities that are payable only in installments can pose liquidity problems because acceleration of an annuity to pay the estate tax attributable to it may be infeasible.
2. Alternatives
 - a. Allow for a Deferral of Payment of Estate Taxes Modeled After the Regulations for Annuities for Non-U.S.-Citizen Spouses That Qualify for the Marital Deduction. Congress could provide for deferral of payment of estate taxes attributable to annuities modeled after existing regulations having to do with annuities for non-U.S.-citizen spouses.
 - b. Allow for a Time Extension for Payment of the Estate Tax Attributable to an Annuity Modeled After IRC §§ 6163 and 6166. Congress could permit an executor to elect to pay all or part of the tax attributable to an annuity on an installment basis if certain requirements were met. It could use its current time extension provisions, such as IRC §§ 6163 and 6166, as models in designing the limitations, payment schedules, and acceleration of payment rules.

P. Time Extension for Payment of Estate Taxes under IRC § 6166

1. Issue: IRC § 6166, which provides an extension of time for the payment of estate taxes for estates owning closely held businesses, may not be as effective as other approaches in solving estate liquidity problems.
2. Alternatives
 - a. Adopt a Modified Universal Deferral Rule. Congress could modify IRC § 6166 by eliminating the 35 percent qualification test while continuing to limit deferral of the estate tax to estates with illiquid assets.
 - b. Adopt a Universal Deferral Rule. Congress could extend the tax due date for all estates to, for example, three years after the date of the decedent's death, while imposing interest from the end of the current nine-month period after the date of death.
 - c. Permit Prepayment of Estate Tax. Congress could allow advance payments of estate tax. One approach would be for

the government to credit the prepayments with interest determined from the time the government receives the payments. Another approach would be to have the payment based on the valuation of an asset determined at the time of payment. Both the government and the estate would be bound by the valuation determination at the taxpayer's death.

Q. Qualified Family-Owned Business Interests (QFOBI)

1. Issue: The qualification requirements under IRC § 2057, which provides a deduction for a qualified family-owned business interest after 2010, are complex and difficult to administer.
2. Alternatives. The EGTRRA repealed IRC § 2057 for decedents dying after 2003 but reinstates it for decedents dying after 2010. The following suggested modifications to IRC § 2057 address the complexity of the qualification requirements that will apply after 2010.
 - a. Eliminate the 50 Percent Test. Congress could eliminate the requirement that more than 50 percent of a decedent's adjusted gross estate consists of a QFOBI.
 - b. Repeal the Adjustment to a Decedent's Adjusted Gross Estate for Gifts to the Decedent's Spouse. Congress could repeal IRC § 2057(c)(2)(A)(ii), which increases the amount of the adjusted gross estate for the purpose of determining qualification under the 50 percent test by the amount of non-*de minimis* gifts that a decedent has made to the decedent's spouse within the ten-year period ending at the decedent's death.
 - c. Repeal the Material Participation Requirement. Congress could repeal IRC § 2057(b)(1)(D), which requires that a decedent or a member of the decedent's family materially participate in the operation of the trade or business for certain periods of time immediately preceding the decedent's death.
 - d. Impose Interest on the Recapture Tax from the Time of the Recapture Event. Congress could modify IRC § 2057(f)(2)(A)(ii), which imposes interest on the recapture tax "for the period beginning on the date the estate tax liability was due," to impose interest on the recapture tax for the period beginning on the date of the recapture event.

- e. Clarify That Dispositions in the Ordinary Course of Business Are Not Recapture Events. Congress could clarify that dispositions that are part of the ordinary course of an active business, such as dispositions of inventory and equipment, are not dispositions that would result in a recapture tax under IRC § 2057(f).
- f. Authorize an IRC § 2057 Election for a Partial Interest in a QFOBI. Congress could modify the statute to authorize an IRC § 2057 deduction for some, but not all, of a QFOBI.
- g. Amend IRC § 2056(b)(9) to Allow a QFOBI to Fund a Marital Deduction Bequest. Congress could amend IRC § 2056(b)(9), which prevents an estate from claiming an estate tax deduction more than once with respect to the same property, to allow QFOBIs to fund marital deduction bequests.

IX. The Generation-Skipping Transfer Tax

A. The Estate and Gift Tax Override

- 1. Issue: Transferors must engage in sophisticated planning techniques to prevent their beneficiaries from having to pay more under the GST tax than they would if the interests they received were subject to the estate or gift tax.
- 2. Alternative: Provide Taxpayers the Right to Elect the GST Tax or the Estate or Gift Tax. Congress could give taxpayers the right to elect to be subject to either the GST tax or the estate or gift tax.

B. The Coordination of the GST Tax with the Estate and Gift Taxes

- 1. Issue: The gift tax annual exclusion is coordinated with the GST tax for some, but not all, transfers, creating unfairness, confusion, and complexity.
- 2. Alternatives
 - a. Exclude from the GST Tax All Transfers That Qualify for the Gift Tax Annual Exclusion. Congress could exclude from the GST tax all transfers that qualify for the gift tax annual exclusion, regardless of whether they are outright transfers or transfers to trusts and regardless of whether they are direct skips.
 - b. Allow the Annual Exclusion for Gifts in Trust Only if the Transfers Meet the Requirements of IRC § 2642(c).

Congress could allow an annual exclusion for gifts made in trust, but only if the transfers meet the IRC § 2642(c) requirements.

- c. Modify the Gift Tax Annual Exclusion and Enact Comparable Rules to Assure Nontaxation under the GST Tax. Congress could adopt new requirements for the gift tax annual exclusion and coordinate the GST tax accordingly to assure nontaxation under the GST tax of transfers that qualify for the gift tax annual exclusion.

C. Credit for Tax on Property Previously Taxed

1. Issue: The estate tax does not provide a tax credit for property previously taxed within a short period of time under the GST tax; the GST tax does not provide a tax credit for property previously taxed within a short period of time under the gift, estate, or GST taxes; and the direct skip rules, when determining the GST tax liability, fail to take into account that a credit for previously taxed property might have been available to a non-skip person under the estate tax.
2. Alternative: Expand the Credit for Previously Taxed Property to Take into Account the GST Tax. Congress could expand the previously taxed property credit to allow for a credit when: (1) a generation-skipping transfer by reason of death occurs within a stated time period of a previous generation-skipping transfer, or (2) a generation-skipping transfer by reason of death occurs within a stated time period of a previous gift or estate tax transfer.

D. Disclaimers

1. Issue: The rules generally allow succeeding beneficiaries nine months to disclaim their interests received upon a taxable transfer under the estate or gift tax law, but they do not provide a nine-month period for succeeding beneficiaries to disclaim after a taxable transfer occurs under the GST tax law.
2. Alternative: Amend the Regulations to Permit a Beneficiary of a Future Interest Held in Trust to Make a Qualified Disclaimer After a Taxable Transfer. Treasury could amend the regulations to provide that a beneficiary of a future interest held in trust has nine months from the time of a taxable event to make a qualified disclaimer for transfer tax purposes, whether the transfer tax in question is an estate tax, a gift tax, or a GST tax.

E. Basis Adjustment for Taxable Terminations

1. Issue: The basis adjustment rules for taxable terminations that occur as a result of death do not conform to the basis adjustment rules for successive outright transfers resulting from death.
2. Alternative: Eliminate the Limitation on the Basis Adjustment for Taxable Terminations Occurring as a Result of Death. Congress could eliminate the limitation on the basis adjustment for taxable terminations occurring as a result of the death of an individual by repealing the following language found in IRC § 2654(a)(2): “except that, if the inclusion ratio with respect to such property is less than 1, any increase or decrease in basis shall be limited by multiplying such increase or decrease (as the case may be) by the inclusion ratio.”

F. State Death Taxes

1. Issue: The GST tax law does not provide a deduction for state death taxes comparable to the one that takes effect under the estate tax law in 2005, and the GST tax law does not permit either a credit or a deduction for state GST taxes resulting from a direct skip.
2. Alternatives
 - a. Amend the GST Tax Law to Provide for a Deduction for State Death Taxes After 2004. Congress could provide a deduction to replace the credit for state GST taxes under IRC § 2604, which the EGTRRA repeals after 2004.
 - b. Provide for State GST Taxes on Direct Skips. Congress could extend IRC § 2604 to permit a credit for state GST taxes assessed against a direct skip occurring upon the death of an individual. If Congress replaces the credit with a deduction after 2004, it also could allow a deduction for state GST taxes assessed against a direct skip occurring upon the death of an individual.

G. The Estate Tax Inclusion Period (ETIP)

1. Issue: The ETIP rule adds to the complexity of the GST tax law because it makes most transfers that are “incomplete” for estate tax purposes also incomplete for certain GST tax purposes, even if they are complete for gift tax purposes.

2. Alternatives
 - a. Repeal the ETIP Rule. Congress could repeal IRC § 2642(f), which establishes the ETIP rule.
 - b. Retain the ETIP Rule but Repeal the Spousal Rule. If Congress retains the ETIP rule, it could, nevertheless, repeal the spousal rule found in IRC § 2642(f)(4).

H. Assignments of Remainder Interests

1. Issue: The GST tax consequences of a transfer of a remainder interest are unclear, and the GST tax rules regarding the transfer of a remainder interest may not conform to the estate tax and gift tax rules.
2. Alternative: Clarify the GST Tax Rules to Conform to the Estate and Gift Tax Rules by Treating the Actuarial Value of a Remainder Interest as the Full Value of the Underlying Property Encumbered by the Term Interest. Congress could provide by statute that, for the purpose of the GST tax, the transfer of a remainder interest changes the transferor of the underlying property to the extent of the portion of the remainder interest transferred, whether the transfer is subject to the estate or gift tax or would be subject to the estate or gift tax but for the receipt of full and adequate consideration.

I. IRC §§ 2701 and 2702

1. Issue: The Code and regulations are unclear as to whether the special valuation rules of IRC §§ 2701 and 2702 apply to determine GST tax liability.
2. Alternative: Clarify That IRC §§ 2701 and 2702 Apply to Determine the GST Tax Liability on a Direct Skip. Congress or Treasury could clarify that IRC §§ 2701 and 2702 apply to establish the value of property for the purpose of determining the GST tax on a direct skip.

J. The GST Exemption

1. Issue: The GST exemption rules encourage the use of multiple long-term trusts and place a high premium on timely and effective allocation of the GST exemption.

2. Alternatives
 - a. Reset the Inclusion Ratio to One After a Period of Years. Congress could require that a trust take an inclusion ratio of one after a period of years, say, for example, 90 years.
 - b. Recalculate the Inclusion Ratio After the Occurrence of Either a Taxable Termination or a Taxable Distribution to Another Trust. Congress could permit the GST exemption to eliminate the GST tax on only one taxable generation-skipping transfer.
 - c. Allow a Trustee to Allocate Distributions to Exempt and Nonexempt Portions of a Trust. Congress could allow a trustee to allocate distributions within a trust to exempt and nonexempt portions of the trust.
 - d. Eliminate the Inclusion-Ratio System and Permit a Trustee to Elect Which Generation-Skipping Transfers Use the GST Exemption Allocated to the Trust. Congress could eliminate the inclusion-ratio system now in place and, instead, authorize a trustee to assign the GST exemption allocated to a trust to generation-skipping transfers.
 - e. Repeal the GST Tax and Impose a Periodic Tax on Trusts. Congress could repeal the GST tax altogether and impose a periodic tax on trusts, except those that are for the sole benefit of a single beneficiary and are includable in the estate of that beneficiary.

K. Direct Skips

1. Issue: The problems associated with direct skips may outweigh their benefits of preventing taxpayers from avoiding the GST tax through “layering.”
2. Alternatives
 - a. Limit Generation-Skipping Transfers to Taxable Terminations and Taxable Distributions. Congress could repeal IRC § 2612(c) and not treat direct skips as generation-skipping transfers.
 - b. Reduce the Rate of Tax on Direct Skips. Congress could reduce the rate of the GST tax on direct skips.

L. Transfers to Persons Unrelated to the Transferor

1. Issue: Transferors are not likely to make transfers to young, unrelated persons to avoid the estate and gift taxes, and a GST tax on these transfers causes complications in planning.
2. Alternative: Exclude Gifts to Nonrelatives from GST Tax. Congress could exclude transfers to nonrelatives from the GST tax.

M. Generation Assignments of Persons Unrelated to the Transferor

1. Issue: If the typical generation is 25 years long, the generation assignment rules assign nonrelatives to more remote generations than they should be assigned.
2. Alternative: Change the Generation Assignment Rules for Unrelated Persons. Congress could amend IRC § 2651(d) and assign all unrelated persons not more than 25 years younger than the transferor to the transferor's generation, all unrelated persons more than 25 years but less than 50 years younger than the transferor to the same generation as the transferor's child, and all unrelated persons more than 50 years but not more than 75 years younger than the transferor to the same generation as the transferor's grandchild, and so forth.

X. Alternatives to Present Transfer Tax System

A. Alternatives Considered

1. The Task Force reviewed three alternatives to the existing transfer tax system: (a) an accessions tax (a separate tax on an individual's cumulative receipts of gratuitous transfers), (b) inclusion of receipts of gratuitous transfers in gross income (repealing IRC §§ 101(a) and 102(a)), and (c) treating a gratuitous transfer as a deemed-realization event for income tax purposes.
2. In reviewing the alternatives, it is important to keep in mind that, regardless of designation, the ultimate burden of *all* transfer taxes falls on the *transferee*, not the transferor. Under the existing transfer tax system, the tax, although nominally on the transferor or his or her estate, is ultimately the burden of the transferee, whose receipt will be measured by the amount committed to the transfer, less allocated taxes. The same is true of any income tax on the transferor generated by a deemed-realization system. The accessions tax and income-inclusion systems are keyed to the situations of the transferees. Under an accessions tax, the tax base is established by reference to the cumulative lifetime gratuitous

receipts of the transferee, and the tax is imposed directly on the transferee. Under the income-inclusion system, the tax is likewise imposed on the transferee and the tax is calculated with reference to the taxpayer's other income and deductions incurred in the year of receipt.

3. Many of the problems under the present system would arise under one or more of the alternatives. For example, valuation is an issue with each of the alternatives. Also, the deemed-realization system would entail rules for determining the basis of deemed-realization assets that would be formulated in part with reference to options available for carryover basis.

B. Accessions Tax

1. The accessions tax is an excise tax on the receipt of a gratuitous transfer of property, assessed on the basis of the transferee's cumulative lifetime receipts of gratuitous transfers. The tax would be computed by determining the value of the receipt, subtracting deductions and exemptions, adding prior years' receipts, computing the tax on the result, and then subtracting the tax "on" the prior years' receipts. Each transferee would have a cumulative lifetime exemption; taxable accessions (net of any exclusions and deductions) would be subject to a rate schedule that could either be flat or graduated. To the extent that generation-skipping transfers are a concern, one or more mechanisms might be devised to achieve the effect of imposing a higher tax on receipts from family members two or more generations above the transferee.
2. As a tax based on lifetime receipts by the transferee, the accessions tax promotes equality of treatment among similarly situated transferees, without regard to the timing of accessions or the circumstances surrounding the receipt. Under the existing transferor oriented system, an individual who receives all of a \$4 million estate is treated far less favorably than a similarly situated individual who receives all of four \$1 million estates. Similarly, an individual who receives one-fourth of a \$4 million estate is treated far less favorably than one who receives all of a \$1 million estate. These inequalities would disappear in a transferee-oriented system such as the accessions tax.
3. Generally, transfers under the existing transfer tax system would result in accessions under an accessions tax. Receipts from a spouse would be excludible (in whole or in part), and receipts by a charity would be free of tax (because the charity itself would be exempt from tax). A de minimis rule would be adopted to screen

out small receipts of cash, holiday and “occasion” gifts, and consumption-item gifts.

4. Liquidity concerns relating to business assets and other “tax preferred” assets could be addressed by rules deferring the taxable event or, as under the existing transfer tax system, deferring the tax (with or without a below-market interest charge).
5. Valuation issues would be similar to those under the present system, and the key issues would revolve around whether to value what was received or what the transferor had.
6. Prior proposals relating to an accessions tax have grappled with difficult issues relating to receipts by and through trusts. The problem stems from the fact that a trust is not now thought of as a taxable person in its own right. Under the current view of trusts, accessions would be deemed to occur upon the occurrence of trust distributions (rather than the completion of the transfer into trust or the vesting of trust interests). Both income and corpus distributions would constitute taxable accessions. (This “deferral” aspect of an accessions tax stands in sharp contrast to the existing gift and estate tax, where transfers can occur no later than the transferor’s death.)
7. Exemptions and rates aside, deferral is revenue neutral so long as all distributions (income and corpus) are included in the tax base. Nevertheless, taxpayers might obtain an advantage with respect to a given trust if the taxable event could be accelerated, e.g., to the date the trust is created. Probably the system should be designed to resist such accelerations.
8. As control of wealth can be viewed as itself being a valuable asset even without distributions, a possible design option would be to impose a tax (probably at a high flat rate) on the trust’s receipt of assets in excess of a certain large threshold amount, with distributions to beneficiaries (which would include a gross-up for the taxes paid by the trust) entitling the distributee to a refundable credit for taxes paid by the trust. Other difficulties identified in the accessions tax concept include neutralizing the incentive to scattering accessions to multiple (presumably low-bracket individuals) and the GST issue.

C. Income-Inclusion System

1. A comprehensive tax base encompassing gratuitous transfers could be attained by effectively repealing IRC §§101(a) (excluding receipts of insurance proceeds from gross income) and 102(a)

(excluding receipts of gifts and bequests from gross income). This would subject the recipient of a gratuitous transfer to annual income tax at progressive rates; the transferor would not be entitled to an income tax deduction for gratuitous transfers (other than transfers incident to a divorce and transfers to charity allowed as deductions under existing income tax laws).

2. Similar to the accessions tax, the income-inclusion model is a transferee-oriented system, with the taxable event being the time of receipt (as opposed to transfer or vesting). One fundamental difference between this approach and the accessions tax is the computation of the tax base – in the accessions tax it is cumulative from year to year and in the income-inclusion system each year starts fresh. Accordingly, a lifetime exemption is inappropriate for an income tax, which taxes all income from whatever source derived, subject to an annual allowance system producing a zero bracket amount “at the bottom” roughly equivalent to a subsistence level. Nevertheless, de minimis rules excluding inter vivos gifts of a low amount or of a consumption character would undoubtedly be part of any such system. Qualifying marital transfers would be excluded. Charities would not pay tax on contribution income, but the contributions presumably would be deducted as under current law.
3. Accommodation can be made for “problem” assets (hard to value assets and politically-favored assets like family farms) by deferring tax at the “price” of obtaining a zero basis. Alternatively, an accrued tax can be deferred, with or without below-market interest. As with the accessions tax, valuation philosophy must be addressed.
4. In contrast to the accessions tax system, trusts (other than grantor trusts) are separate taxpayers under the income tax. Accordingly, the trust would treat inception corpus as gross income, presumably taxed at trust rates. Otherwise, trusts and beneficiaries would be taxed under the present IRC Subchapter J system.
5. If the income-inclusion system is viewed as a form of transfer tax (i.e., like an accessions tax with a different tax base), issues such as generation-skipping may arise. Any solution to such a problem could take the form of a periodic tax on trust assets or an excise tax on trust assets keyed to shifting enjoyment of trust income or corpus.

D. Deemed-Realization System

1. A deemed-realization system entails a modification of the income tax to the effect that gratuitous transfers would be realization events for income tax purposes, triggering gain or loss to the transferor. The amount realized would be the fair market value of the asset at the time of transfer, and the basis would be the transferor's adjusted basis. The transferee would acquire a fair market value basis in all cases. Life insurance gains on death would be treated as actual realization events. Similarly, gains in pension accounts, individual retirement accounts, and income in respect of a decedent would be taxed on the decedent's final return.
2. A deemed-realization system has existed in Canada since 1972. The United Kingdom and Australia (both of which have transfer tax systems) treat inter vivos gifts (but not bequests) as deemed-realization events.
3. The taxpayer would be the transferor. Rules would be needed to determine when a transfer becomes complete. Transfers at death would appear on the transferor's final income tax return, along with unused capital loss and net operating loss ("NOL") carryovers. A large positive ordinary-gain net amount on a final return could be eligible for income averaging or possibly be subject to a special rate schedule. Any net loss would be carried back.
4. Qualifying marital transfers would be excluded from the deemed-realization rule. Instead, the carryover basis rules of IRC § 1041 would be extended to marital bequests, as well as gifts. A carryover-basis system could also be adopted for hard-to-value (contingent) assets. The shifting of trust enjoyment solely to a charitable beneficiary would not be a realization event, but a shift from charitable to non-charitable enjoyment would be. Certain gains on a personal residence could be treated as they are in the current system. In addition, an exemption system could be adopted to remove small transfers from the system and to avoid subjecting to tax transfers that, under the current system, attract no estate tax but provide a fair market value cost basis.
5. Trust transfers pose no special problems. Presumably, transfers out of the trust would be deemed-realization events. To the extent deemed realization is viewed as a transfer tax stand-in, issues such as generation-skipping could be addressed by deeming trust assets as sold (and repurchased) at periodic (e.g., twenty-five year) intervals.

XI. Conclusion

A. Change to the Transfer Tax System Is Coming!

1. Taxpayers cannot tolerate the uncertainty and inequality that currently exists in the transfer tax system.
2. Congress will react to taxpayer pressure to make changes. A good prediction is that change will occur in the time period 2004 to 2006, but clearly after the 2004 elections.
3. It is impossible to predict what the changes will be, but some of the more likely changes may include:
 - a. Increase in estate tax exclusion,
 - b. Increase in benefits to closely held businesses, and
 - c. Elimination or curtailment of valuation discounts for entities owning passive assets.

B. Financial Advisers Must Be Prepared for Change.

1. Financial service providers must be prepared for the changes that will occur in the transfer tax system and alert clients to the probability of change.
2. Flexibility in estate planning documents will be the watchword.

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