

**REPORT ON REFORM OF  
FEDERAL WEALTH TRANSFER TAXES**

**EXECUTIVE SUMMARY**

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Sponsoring Organizations: The American Bar Association's Section of Real Property, Probate and Trust Law, the American Bar Association's Section of Taxation, the American College of Tax Counsel, the American College of Trust and Estate Counsel, the American Bankers Association, and the American Institute of Certified Public Accountants.

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# TASK FORCE ON FEDERAL WEALTH TRANSFER TAXES

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## INTRODUCTION

The American Bar Association's Section of Real Property, Probate and Trust Law, the American Bar Association's Section of Taxation, the American College of Tax Counsel, the American College of Trust and Estate Counsel, the American Bankers Association, and the American Institute of Certified Public Accountants contributed resources and personnel to the development of this Report. In addition, the American College of Trust and Estate Counsel Foundation, the American Tax Policy Institute, and the American Bar Association's Section of Real Property, Probate and Trust Law provided grants to enable the Task Force to complete this Report.

Representatives from each association organized the Task Force with the purpose of producing a report that provides expert analysis of the changes enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA or Act), regarding federal wealth transfer taxes. The Report does not consider policy questions having to do with the economic effects of a wealth transfer tax system as compared to other systems of taxation. It also does 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 (GST) taxes, the phaseout period, the continuation of the gift tax after repeal, the modified carryover basis rule, and the alternatives to federal wealth transfer tax repeal.

The Report is designed to provide diverse views and perspectives on a wide range of issues concerning the current federal wealth transfer tax system and the changes the EGTRRA makes to that system. With most issues it identifies, the Report suggests options that Congress might consider, but it does not make specific recommendations for regulatory or legislative action. The order in which the Report lists alternative approaches is not intended to represent the Task Force's preference for one over another. The Task Force members and sponsoring organizations support the analysis of the alternative solutions to the issues identified, but do not endorse any specific solution. The Task Force 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 listings of alternatives.

This Executive Summary assists readers by providing an overview of the scope of the Report. It briefly describes the issue raised under a topic and the possible approaches Congress or Treasury might take to resolve the issue. Readers can use the Executive Summary to find a specific area of interest and then turn to the Report for a detailed analysis of current law and a critique of alternative approaches to the issue raised.



**PART I**  
**THE PHASEOUT OF THE ESTATE AND GST TAXES**  
**AND THEIR SUBSEQUENT REINSTATEMENT**

**§ 1. Inadequate Estate Plans**

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.

*Alternatives*

1. Recognize a State Law's Doctrine of Reformation. Congress could recognize a reformation of a will or other governing instrument that a state court makes to conform the terms of an instrument to a transferor's intentions, 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 demonstration that the reformation furthered the transferor's intent.

2. Authorize a Qualified Transfer Made in Furtherance of a Transferor's Intent. Congress could permit a recipient to make a transfer of an interest that that recipient has received from a decedent as if that recipient was acting under a durable power of attorney or a power of appointment. A qualified transfer could operate either in conjunction with, or instead of, congressional recognition of court-approved reformations of governing instruments.

**§ 2. Planning Under a Lengthy Phaseout Period**

Issue: The lengthy phaseout period of the estate and GST taxes causes complexities and uncertainties as taxpayers engage in financial and estate planning, and the EGTRRA's treatment of gift taxes and GST taxes during the phaseout period further exacerbates a taxpayer's planning difficulties.

*Alternatives*

1. Reduce the Length of the Phaseout Period. If Congress repeals the estate and GST taxes permanently, it could reduce the length of the phaseout period and thereby reduce planning complexity.

2. Reunify the Estate and Gift Taxes During the Phaseout Period and Repeal the GST Tax Immediately. If Congress repeals the estate and GST taxes permanently, it could reunify the estate and gift taxes during the phaseout period and repeal the GST tax immediately.

3. Repeal the Gift Tax. If Congress repeals the estate and GST taxes permanently, it could repeal the gift tax along with the GST and estate taxes.

4. Modify the Estate, Gift, and GST Taxes. If Congress decides not to repeal the estate and GST taxes, it could, instead, modify the estate, gift, and GST taxes that currently are in place.

5. Adopt a Tax System Other than a Wealth Transfer Tax System. If Congress decides permanently to repeal the current wealth transfer tax system, including the gift tax, it could replace it with: (i) an accessions tax, in which transferees would be subject to a tax on their cumulative lifetime receipts of gratuitous transfers; (ii) 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 (iii) a deemed-realization system, in which the law would treat donative transfers as realization events for income tax purposes.

### **§ 3. State Death Tax Credit**

Issue: The EGTRRA's phaseout and repeal of the state death tax credit, accompanied by its introduction of a deduction for state death taxes, create planning complexities and uncertainties.

#### *Alternatives*

1. 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 to recognize state-authorized reformation of a decedent's governing instruments.

2. Reduce the Length of the Phaseout Period. If Congress decides to repeal the estate and GST taxes permanently, it 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 to reduce the length of the phaseout period.

3. Restore the State Death Tax Credit. If Congress decides not to repeal the estate and GST taxes permanently, Congress could restore the state death tax credit as it applied before the EGTRRA changes.

4. Retain the State Death Tax Credit at 50 Percent for 2004 or Accelerate the Deduction to 2004. Congress could retain the state death tax credit at 50 percent in 2004 or accelerate the deduction to 2004 in order to avoid taxing estates of decedents dying in 2004 significantly more harshly than estates of decedents dying in other years.

### **§ 4. Temporary Repeal**

#### **A. Repeal of the Estate Tax and Introduction of the Modified Carryover Basis Rule**

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.

*Alternatives*

1. 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.

2. Allow Estates of Decedents Dying in 2010 to Elect to Be Subject to the Estate Tax Law in Effect in 2009. If the repeal remains in place for one year, Congress could allow executors of the estates of decedents who die in 2010 to elect whether they want those estates to be subject to the law in place as of 2009, rather than the law in place for the year 2010.

**B. Repeal of the GST Tax**

*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.

*Alternatives*

1. Enact Clarifying Transition Rules. 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.

2. Make the Technical Provisions Permanent. Congress could make the technical provisions of the EGTRRA, which Congress intended to help taxpayers avoid inadvertent imposition of the GST tax, permanent.

**PART II  
THE GIFT TAX**

**§ 5. Domestic Transfers**

*Issue:* The EGTRRA's treatment of the gift tax may not be a well-tailored solution for addressing the potential income tax abuse arising from transfers between U.S. taxpayers, and it could create enforceability problems, encourage gift tax avoidance strategies, and interfere with nontax estate planning goals.

*Alternatives*

1. Repeal the Gift Tax and Issue Regulations on Agency Relationships Between U.S. Transferors and Transferees. 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 implicitly or explicitly has agreed to return the asset, either directly or indirectly, to the transferor.

2. Repeal the Gift Tax and Treat a Gift as a Realization Event, Unless a Donor Elects to Be Treated as the Continuing Owner for Income Tax Purposes. Congress could repeal the gift tax and treat a 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. Congress, however, may want to deny a donor the right to elect to treat the gift as a realization event if the transfer would result in a loss.

3. Repeal the Gift Tax and Tax a Donee's Disposition of an Asset Acquired by Gift at the Highest Applicable Tax Rate. 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. 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 sales or dispositions of assets they receive by gifts against capital losses from the dispositions of their other assets.

4. Retain the Gift Tax Accompanied by a Grantor Trust Election. Congress could retain the gift tax but allow donors to avoid the gift tax, if they elect grantor trust treatment. If a donor elects grantor trust treatment for gifts made in trust, distributions from the trust to a beneficiary would be treated as taxable gifts at the time of distribution. Congress could consider not treating distributions of income to beneficiaries as completed gifts.

5. 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 in which the transfer is solely for the purpose of income tax avoidance. It also could make valuation discounts and other valuation techniques applicable only for transfers that do not have as their sole purpose income tax avoidance.

6. Include Form 1040 Questions. To assist in the enforcement of any of the five preceding proposals, the Internal Revenue Service could include on Form 1040 questions to assist in the enforcement of any of those proposals.

## **§ 6. Transfers to Non-U.S. Transferees**

Issue: The EGTRRA's treatment of the gift tax may not be a well-tailored solution for addressing the potential income tax abuse from transfers by U.S. taxpayers to non-U.S. transferees, and it could create enforceability problems and interfere with nontax estate planning goals.

### *Alternatives*

1. Repeal the Gift Tax and Issue Regulations on Agency Relationships Between U.S. Transferors and Non-U.S. Transferees. 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 non-U.S. transferee implicitly or explicitly has agreed to return the asset, either directly or indirectly, to the transferor.

2. Repeal the Gift Tax and Treat a Gift as a Realization Event, Unless the Donor Elects to Be Treated as the Continuing Owner. Congress could repeal the gift tax and treat the transfer of property by a U.S. taxpayer to a non-U.S. transferee as a realization event. Congress also may want to adopt a *de minimis* rule that allows U.S. transferors to make annual gifts of assets, which,

when aggregated, have a relatively low value, without prompting treatment of those gifts as realization events.

3. Repeal the Gift Tax and Treat as Gross Income Cash or Property a U.S. Transferee Receives from a Non-U.S. Transferor. Congress could repeal the gift tax and establish a presumption that all incoming transfers received, directly or indirectly, from a non-U.S. transferor are includable in a U.S. transferee's income. It could then give the transferee the right to rebut the presumption. The U.S. transferee would have to show either that any combination of the original outgoing transfer and incoming transfer did not result in significant tax savings or that the transfers did not constitute abuse that Congress sought to prevent.

## **PART III BASIS**

### **§ 7. General Rules**

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 demonstrates the need for significant changes in estate planning strategies, especially with regard to planning for closely held businesses, as well as some opportunities for simplification.

#### *Alternatives*

1. Treat Unrecognized Losses Consistently. 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 the decedent's death, then for the purpose of determining a loss upon a subsequent sale or exchange, the recipient's basis is the asset's fair market value at the decedent's death. This rule would correspond to IRC § 1015. 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. Yet a third approach would be 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.

2. Retain IRC § 1014 for Tangible Personal Property Not Held for Investment or Used in a Trade or Business. Congress could retain IRC § 1014, 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. To the extent a decedent's eligible assets would exceed the IRC § 1014-type allocation, those remaining assets would be eligible for the basis increases provided under IRC § 1022(b) and (c). Congress could reduce the amount of the basis increases to take into account the availability of an IRC § 1014-type allowance.

3. Clarify the Income Tax Treatment of Charitable Remainder Trusts. Congress or Treasury could clarify whether a testamentary transfer to a charitable remainder trust will cause such a trust to qualify as a charitable remainder trust under IRC § 664. Congress further could allow an income tax deduction to the decedent or to the estate or trust of the decedent under IRC § 642(c).

4. Adjust Basis for State Death Transfer Taxes and Foreign Death Taxes. Congress could allow an adjustment to basis for state death taxes under IRC § 1022 and for state gift taxes under IRC § 1015. Congress also could adjust basis under IRC § 1022 for foreign death taxes. If Congress permits a basis adjustment for state death taxes and foreign death taxes, it may want to deny any such additions to basis to the extent they would result in a basis in excess of the asset's fair market value at the time of the transfer. This would be consistent with the rules for IRC §§ 1015 and 1022.

5. Allow an Executor to Elect to Adjust Basis for Estate Administration Expenses. Congress could allow an executor to elect to treat all or a part of an 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.

## **§ 8. Property Subject to Debt**

Issue: IRC § 1022(g) may create opportunities for tax avoidance at the same time that it may create potential unfairness for a recipient with a tax liability in excess of the equity in the property acquired from a decedent.

### *Alternatives*

1. Establish a Right of Recovery by a Recipient of Encumbered Property from the Other Recipients of a Decedent's Property. Congress could establish a right of a recipient of encumbered property to recover from the other recipients of a decedent's property 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 the income tax liability exceeds the recipient's equity in the property at the time of sale or other disposition. Congress also could 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.

2. 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.

3. 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 asset and the amount of the encumbrances on the asset 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 asset.

4. 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 property's fair market value reduced by its associated indebtedness.

5. 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. In conjunction with the tax avoidance rule, Congress could limit the recipient's tax liability to the amount of equity in the encumbered property, measured at the time the recipient sells or otherwise disposes of it.

6. 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. If a decedent places in the same trust or some other tax entity property encumbered with debt in excess of its adjusted basis, as well as other property sufficient to satisfy the likely tax liability upon disposition of the encumbered property, then Congress could allow IRC § 1022(g)'s carryover basis rule to apply.

## **§ 9. Income in Respect of a Decedent (IRD)**

### **A. Qualified Retirement Plans and IRAs**

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

#### *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. It could deny basis increases for the amounts contributed by the employer or the employee, which represent deferred compensation.

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.

## **B. Installment Sales**

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

### *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.

## **C. State Death Taxes**

Issue: Neither IRC § 691 nor IRC § 1022 provides an adjustment to basis for state death taxes paid on items of IRD.

### *Alternatives*

1. Permit a Deduction Under IRC § 691 for State Death Taxes Attributable to an Item of IRD. If states continue to impose 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 a deduction for state death taxes attributable to an item of IRD.

2. 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 basis for state death taxes attributable to an item of IRD.

## **§ 10. Unused Loss Carryovers and Built-In Losses**

Issue: IRC § 1022(b)(2)(C)'s basis adjustments for net operating losses and capital loss carryovers 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.

*Alternatives.* The following 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.

1. Extend IRC § 1022(b)(2)(C) to Include Losses in Excess of Basis Under IRC §§ 704(d) and 1366(d). Congress or Treasury could extend IRC § 1022(b)(2)(C) to include partnership and S corporation losses that IRC §§ 704(d) and 1366(d) respectively disallowed. If Congress or Treasury were to allow a basis increase under IRC § 1022(b)(2)(C), it may want to allow an adjustment only for the purpose of increasing the basis of a decedent's interest in the pass-through entity, which is the source of the suspended loss.



2. Extend IRC § 1022(b)(2)(C) to Include At-Risk Losses Under IRC § 465. Congress or Treasury could extend IRC § 1022(b)(2)(C) to include losses suspended by the application of IRC § 465. If Congress or Treasury were to allow a basis increase under IRC § 1022(b)(2)(C) for suspended at-risk losses, it may want to allow an adjustment only for the purpose of increasing the basis of a decedent's at-risk amount, which is the source of the suspended loss.

3. Extend IRC § 1022(b)(2)(C) to Include Passive Activity Losses Under IRC § 469. Congress or Treasury could extend IRC § 1022(b)(2)(C) to include losses suspended by the application of IRC § 469. If Congress or Treasury were to allow a basis increase under IRC § 1022(b)(2)(C) for suspended passive activity losses, it may want to allow an adjustment only for the purpose of increasing the basis of a decedent's interest, which is the source of the suspended passive activity loss.

## **§ 11. Aggregate Spousal Property Basis Increase**

### **A. Qualified Spousal Property**

#### 1. Estate Trusts

Issue: The statutory language is unclear as to whether estate trusts qualify for the aggregate spousal property basis increase.

#### *Alternatives*

a. Clarify the Treatment of Estate Trusts. Although estate trusts are not common, Congress or Treasury could clarify whether or not the current language includes estate trusts as qualified spousal property.

b. Include Estate Trusts in the Definition of Qualified Spousal Property. If Treasury were to decide that current language is insufficient to treat estate trusts as qualified spousal property, Congress could amend the statute to include estate trusts as qualified spousal property. It could do so either by adding a subparagraph (C) to IRC § 1022(c)(3) that states that an estate trust is qualified spousal property and defining it, or by amending the definition of outright transfer property to include any interest acquired by a surviving spouse or acquired by a trustee of an estate trust held on behalf of a surviving spouse.

#### 2. Qualified Terminable Interest Property (QTIP)

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.

#### *Alternatives*

a. Clarify the Treatment of Legal Life Estates. Congress or Treasury could clarify, either by statutory amendment or regulation, that legal life estates constitute QTIPs.

b. Clarify the Treatment of Unitrust Interests. Treasury could clarify that unitrust interests constitute qualifying income interests for life under IRC § 1022(c)(5)(B).

c. Clarify the Treatment of QTIPs with Testamentary General Powers of Appointment. Congress could confirm that an income interest granted to a surviving spouse constitutes a QTIP for the purpose of the aggregate spousal basis increase, even if the trust also provides a permissible form of general power of appointment.

d. Treat Trusts in Which Surviving Spouses Have Presently Exercisable General Powers of Appointment as QTIPs. Congress could allow trusts that provide surviving spouses with income interests and presently exercisable general powers of appointment to qualify as QTIPs under IRC § 1022(c)(5).

### **B. Interests in Jointly Owned Property and Community Property**

Issue: IRC § 1022(d)(1) provides more favorable treatment to community property than to jointly owned property.

#### *Alternative*

Treat Property Jointly Owned by a Decedent and the Decedent's Spouse as Owned by the Decedent. Congress could treat 100 percent of property jointly owned by a decedent and the decedent's spouse—whether title is held in a tenancy in common, joint tenancy with the right of survivorship, or tenancy in the entirety—as owned by the decedent for the purpose of IRC § 1022.

### **C. Qualified Spousal Property Owned at the Death of a Surviving Spouse**

Issue: IRC § 1022 permits basis increases for property that surviving spouses own outright at their deaths, but it denies basis increases at the deaths of surviving spouses for QTIPs or for property subject to general powers of appointment.

#### *Alternative*

Treat a QTIP Owned at Death the Same as Property Owned Outright. Congress could amend IRC § 1022(d) to treat property that a surviving spouse receives as qualified spousal property as owned at the death of the surviving spouse.

### **D. Property Transferred to a Spouse Within Three Years of Death**

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 with more favorable treatment than would be available if IRC § 1014(e) were to apply.

#### *Alternative*

Eliminate the Spousal Exception to the General Rule Denying Basis Increases for Property a Decedent Had Acquired Within the Three Years Preceding That Decedent's Death Congress could eliminate the exception that allows one spouse to transfer property to the other spouse within the three years preceding that other spouse's death.

## **E. Noncitizen Decedents and Spouses Who Are Nonresidents**

Issue: The aggregate spousal property basis increase seems to be available to a spouse, regardless of the residency or citizenship status of the decedent or that decedent's spouse, but information return requirements suggest that Congress may intend different treatment for a noncitizen spouse who is a nonresident, if the decedent is a noncitizen and a nonresident.

### *Alternative*

Clarify IRC §§ 1022(c)'s and 6018(b)(3)'s Treatment of Noncitizen Spouses Who Are Nonresidents. Congress or Treasury could clarify whether the aggregate spousal property basis increase is available to noncitizen spouses who are nonresidents, regardless of whether the decedents are noncitizens or nonresidents and regardless of whether noncitizen decedents who are nonresidents owned tangible property situated in the United States.

## **§ 12. Allocation of Basis Increases**

### **A. Decedent's Directives**

Issue: IRC § 1022(d)(3)(A) does not acknowledge that a decedent's directives regarding basis allocation are controlling, and IRC § 1022's approach to basis modifications creates difficult drafting issues that can lead to complexities, uncertainties, and litigation.

### *Alternatives*

1. Acknowledge a Decedent's Directives Are Controlling, and Permit an Executor to Allocate Basis Increases to the Decedent's Beneficiaries Without Reference to the Assets the Beneficiaries Acquired from the Decedent. Congress or Treasury could acknowledge a decedent's directives are controlling. Congress, without regard to the property passing to the beneficiaries, also could permit an executor to allocate: (i) IRC § 1022(b)'s aggregate basis increase among all the beneficiaries of the estate as either the decedent directs or the executor determines, and (ii) IRC § 1022(c)'s aggregate spousal property basis increase to the surviving spouse.

2. Acknowledge a Decedent's Directives Are Controlling, and Permit an Executor to Allocate Basis Increases to the Decedent's Beneficiaries in an Amount Not to Exceed the Fair Market Value of the Property That the Beneficiaries Acquired from the Decedent. Congress or Treasury could acknowledge a decedent's directives are controlling. Congress also could adopt the same rule described in the first alternative, except it could limit the allocation to any beneficiary (including the spouse) to an amount that does not exceed the fair market value of the property passing to that beneficiary.

3. Acknowledge a Decedent's Directives Are Controlling, and Permit an Executor to Allocate Basis Increases to the Decedent's Beneficiaries with the Condition That the Beneficiaries Can Use the Basis Increases Only for Assets Acquired from the Decedent. Congress or Treasury could acknowledge a decedent's directives are controlling. Congress also could adopt the same rule described in the first two alternatives, with the added limitation,

however, that beneficiaries can allocate the amount of basis increases they receive from the executor only to the property they acquire from the decedent.

### **B. A Default Rule**

Issue: IRC § 1022 does not allocate basis increases, if the executor fails to do so.

#### *Alternative*

Provide a Default Rule That Achieves an Approximation of an Allocation That a Dutiful Fiduciary Would Have Made. Congress could provide a default rule based on IRC § 755, having to do with basis allocation in the partnership context. IRC § 755 allocates basis in a manner that “has the effect of reducing the difference between the fair market value and the adjusted basis” of assets in proportion to such differences before the allocation and further provides that the allocation will eliminate ordinary income before capital gain appreciation.

### **C. Allocations to Assets Sold During Administration**

Issue: If IRC § 1022 denies executors the right to allocate the aggregate spousal property basis increase to assets that they sell during administration, in certain circumstances, surviving spouses effectively suffer the resulting higher tax liability assessed against the estate.

#### *Alternative*

Permit a Limited Exception to the Rule That Denies an Allocation of the Aggregate Spousal Property Basis Increase to Assets That an Executor Sells During Administration. Congress could make an exception to the rule that allows an executor to allocate the aggregate spousal property basis increase only to property that a surviving spouse acquires outright or in a QTIP trust. It could permit the executor to allocate the aggregate spousal property basis increase to assets that the executor sells during administration, upon a showing that the sale of other assets would be contrary to the surviving spouse’s financial interest. Alternatively, Congress could permit an allocation of the aggregate spousal property basis increase to assets that the executor sells during administration only if the surviving spouse approves the allocation.

## **§ 13. Compliance and Statute of Limitation Issues Under the Modified Carryover Basis Rule**

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 by the recipients of property acquired from the decedent.

#### *Alternatives*

1. Repeat the Two Types of Lower of Basis or Fair Market Value Rules Found in IRC §§ 1022(a) and 1015(a). Congress could eliminate the rule contained in IRC § 1022(a), which establishes the carryover basis as the lower of a decedent’s adjusted basis in or the fair market value of an asset. The strict carryover basis rule coincides with the treatment that IRC § 1041

provides for property transferred between spouses or incident to a divorce. Congress could extend the recommended treatment of a strict carryover basis rule to IRC § 1015 as well.

2. Allow the Aggregate Basis Increase Only to a Decedent's Estate. Congress could amend IRC § 1022 to allow only the decedent's estate (including any qualified revocable trusts) to use the aggregate basis increase. In order for an estate to enjoy the benefit of IRC § 1022(b)'s aggregate basis increase, however, it would have to make taxable dispositions of the assets to which the executor allocated the basis increase. Congress could ameliorate any disadvantage associated with a rule requiring taxable dispositions during estate administration if it were to apply IRC § 643(e) automatically to distributions to beneficiaries of assets that have received an allocation of the aggregate basis increase under IRC § 1022(b). Further, Congress could amend IRC § 643(e) to limit the amount realized on a deemed sale to be no greater than the asset's modified carryover basis as determined under IRC § 1022.

3. Adopt Procedural Rules to Promote Finality in Determining Basis. Congress could adopt one or more procedural rules that would permit the IRS, by audit, or the executor, by the filing of a declaratory action with the Tax Court or other designated forum having jurisdiction, to obtain a final determination of basis under IRC § 1022 within a reasonable period of time after the estate administration process has commenced.

#### **§ 14. Recharacterization of Income and Loss**

Issue: IRC § 1022, through the application of the basis adjustments under IRC § 1022(b) and (c) and the allocation rules, appears to allow the executor unrestricted discretion to maximize ordinary income deductions and capital gains and to minimize ordinary income and capital losses after the death of the decedent.

##### *Alternatives*

1. Make Basis Increases Available Only to Offset the Amount Realized upon a Disposition. Congress could provide that recipients of assets acquired from a decedent and allocated basis increases under IRC § 1022(b) and (c) have a cost recovery basis, which would not reflect either the aggregate basis increase under IRC § 1022(b) or the aggregate spousal property basis increase under IRC § 1022(c), and a disposition basis, which would reflect both those basis increases. During the time recipients hold assets acquired from a decedent, they would base all cost recovery and amortization allowances on the decedent's adjusted basis. Only when they sell or otherwise dispose of an asset would their gain and loss reflect IRC § 1022's basis increases.

2. Replace Basis Increases with a Credit. Congress could provide an income tax credit to a decedent's estate or to other recipients of a decedent's property, rather than adjustments to basis. The executor would continue to have discretion to allocate the credit to recipients of the decedent's property. Congress could design the credit to reflect the differences in tax rates on capital gains and ordinary income, as well as the tax value of the decedent's loss carryovers and built-in losses, taking into account whether the losses are ordinary or capital. The amount of credit available could reflect the decedent's particular tax history with regard to unrealized

appreciation, previous cost recoveries, loss carryovers, and built-in losses. Alternatively, Congress could determine the amount of the credit on the basis of more generalized assumptions.

3. Preclude the Use of Capital Losses to Offset Ordinary Income. Congress could require that an executor allocate a decedent's capital loss carryovers and built-in losses that would have resulted in capital losses to those assets that would have resulted in capital gains had the decedent sold them immediately before death. Alternatively, Congress could require that an executor allocate the capital loss carryovers and built-in capital losses to those assets that would result in capital gains if their recipients were to sell them immediately after the decedent's death.

### **§ 15. Summary of the Modified Carryover Basis Rule**

Issue: IRC § 1022 introduces a number of new compliance and fairness issues into the income tax law.

#### *Alternatives*

1. Remove Loss Carryovers and Built-in Losses from IRC § 1022(b)'s Aggregate Basis Increase. Congress could repeal IRC § 1022(b)(2)(C) and deny a basis increase for loss carryovers and built-in losses. This amendment to IRC § 1022(b) would leave in place the \$1.3 million aggregate basis increase and the \$3 million aggregate spousal property basis increase.

2. Permit Estates to Allocate an Income Exemption to the Beneficiaries of a Decedent's Estate. Congress could permit an executor to allocate a fixed-dollar amount of income exemption to a decedent's beneficiaries. It further could bind an executor to allocate the income exemption in accordance with the decedent's directions, if found in a valid governing instrument. In the absence of directions from the decedent, the executor could have the authority to make an allocation, and, in the event the executor fails to make the allocation, Congress could establish default rules.

3. Eliminate Basis Increases and Adopt a Strict Carryover Basis Rule. Congress could repeal the basis increases provided in both IRC § 1022(b) and (c). It also could repeal the fair market value limitation found in IRC § 1022(a) and allow a recipient of a decedent's property to take a basis equal to the decedent's adjusted basis in that property, notwithstanding that it exceeds the property's fair market value. Further, Congress, during the period of estate administration, could permit an estate to use a decedent's loss carryovers in a manner similar to the treatment of excess losses of an estate or trust provided in IRC § 642(h).

4. Treat Death as a Realization Event. Congress could treat death as a realization event. Further, Congress could eliminate any restrictions on the deductibility of losses and loss carryovers for the decedent's final year's income tax return or for the estate's first year's income tax return. Congress also could treat lifetime transfers as realization events, thereby, eliminating distinctions between lifetime and deathtime transfers.

## PART IV THE FEDERAL WEALTH TRANSFER TAX SYSTEM

### § 16. The Annual Exclusion

*Issue:* The present interest requirement for annual exclusion gifts, particularly for gifts made in trust, creates complexity and uncertainty.

*Alternatives.* The complexities surrounding the present interest requirement may warrant Congress's modifying the law during the phaseout period, even if Congress otherwise decides to repeal permanently the estate and GST taxes. The modifications that Congress may make to the annual exclusion during the phaseout period, however, may not be appropriate after repeal of the estate and GST taxes, if Congress retains the gift tax to protect the income tax. Income tax avoidance may lead Congress to restrict the annual exclusion to outright, *de minimis* transfers. The alternatives set forth below assume that a wealth transfer tax system is in place.

1. Revise the Present Interest Requirement

a. Retain the Present Interest Requirement and Deny the Annual Exclusion for Gifts Made in Trust. Congress could retain the present interest requirement, but deny annual exclusions for any gifts made in trust, except for those that qualify under IRC § 2503(c), having to do with gifts to minors. Congress may want to conform the GST tax rules and exclude from the GST tax only outright gifts or gifts that qualify under IRC § 2503(c).

b. Retain the Present Interest Requirement and Allow the Annual Exclusion for Gifts Made in Trust That Meet the Requirements of IRC § 2642(c). Congress could retain the present interest requirement, but allow an annual exclusion only for gifts made in trust that meet the IRC § 2642(c) requirements, which ensure that donees are treated, for estate and gift tax purposes, as owners of the property placed in trust.

c. Retain the Present Interest Requirement and Provide That a Withdrawal Power Does Not Meet the Requirement. Congress could retain the present interest requirement and permit gifts made in trust to qualify, but provide that a withdrawal power does not satisfy the present interest requirement.

d. Retain the Present Interest Requirement and Establish Rules for a Qualifying Withdrawal Power. Congress could retain the present interest requirement and codify the rules for a qualifying withdrawal power. If Congress were to codify the rules for a qualifying withdrawal power, Congress also could conform IRC §§ 2041(b)(2) and 2514(e) and provide that a lapse of a power of withdrawal to the extent of the greater of the annual exclusion amount or 5 percent of the value of the trust assets does not constitute a release for either estate or gift tax purposes. Congress further could eliminate the complexities of the withdrawal power by excluding a limited lapsing power of withdrawal from the operation of IRC § 678, which treats a power holder as the owner of a trust for income tax purposes.

2 Eliminate the Present Interest Requirement. Congress could eliminate the present interest requirement and allow both outright transfers and transfers made in trust to qualify for the annual exclusion. Under this alternative, a transfer would qualify for the annual exclusion if the donor made a gift of an interest that is susceptible to valuation. Interests that can be defeated by the exercise of fiduciary or beneficial powers, or are subject to conditions that are not susceptible to actuarial valuation, would not qualify for the annual exclusion, because such transfers would not be susceptible to valuation.

3. Impose Additional or Different Types of Dollar Limitations. If Congress believes the extent of tax-free annual giving to be a problem, Congress could limit the number of gifts by a donor that qualify for the annual exclusion in any given year. Alternatively, Congress could retain the per donee annual limit and not limit the number of potential donees. Instead, Congress could place a limit on the aggregate amount of transfers qualifying for the annual exclusion that a donor can make in any one year. Yet a third option would be to eliminate the per donee annual exclusion and, instead, permit a donor to make aggregate gifts up to some designated amount each year.

4. Expand the Availability of IRC § 2503(e). Congress may want to expand the medical exclusion rule found in IRC § 2503(e) by allowing an exclusion for the payment of medical expenditures that qualify for deduction under IRC § 213. Congress also may want to expand IRC § 2503(e) to cover those expenses that are allowed under IRC § 529(e)(3) for a child under age 26.

## **§ 17. Portability of the Unified Credit and the GST Exemption Between Spouses**

*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 the GST exemption.

*Alternatives.* Even if Congress makes the repeal of the estate and GST taxes permanent, it could implement the portability alternatives set forth below during the phaseout period to ameliorate the planning complexities that arise as a result of the scheduled changes in the applicable exclusion amounts and the GST exemption amount.

1. Allow the Surviving Spouse a Portable Applicable Exclusion Amount at Death. Congress could allow the unused applicable exclusion amount available at the time the first spouse dies to be available as an additional applicable exclusion amount to the surviving spouse. The occasional suggestion to change the unified credit to a unified exemption would not affect this recommendation.

2 Allow the Surviving Spouse a Portable Applicable Exclusion Amount for Transfers Subject to the Gift Tax. Congress could allow the surviving spouse to use the portable applicable exclusion amount for lifetime gifts subject to the gift tax.

3. Limit the Use of a Portable Applicable Exclusion Amount upon Remarriage. Congress could prevent portable applicable exclusion amounts from accumulating without limit as a result



of remarriage. In the case of a surviving spouse who remarries, Congress could limit the portable applicable exclusion amount available to the new spouse, if he or she survives, to the surviving spouse's own applicable exclusion amount.

4. Allow the Surviving Spouse Portability of the GST Exemption. Congress could allow the GST exemption amount that the first spouse to die could have transferred tax free to be available as an additional GST exemption amount to the surviving spouse.

5. Allow the Surviving Spouse Portability of Lower Rate Brackets. Congress could allow the surviving spouse the benefit of unused rate brackets from the estate of the first spouse to die.

## **§ 18. Valuation Discounts and Chapter 14 Valuation Rules**

### **A. Valuation of Interests in Entities and Unique Items of Tangible Property**

*Issue:* The rules that have evolved for valuing interests in entities and unique items of tangible property are inconsistent, create uncertainty, and cause controversy.

*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.

1. Establish Presumptive Valuation Guidelines and Safe Harbors. Congress could establish presumptive valuation guidelines and safe harbors to reduce valuation uncertainty and the controversy that the uncertainty produces. It also could provide for a retroactive adjustment of the valuation discount, if the recipients of the interests sold or otherwise disposed of them within a specified period of time after their having received them. Congress as well, or alternatively, could authorize an adjustment of the statutorily determined discount upon clear and convincing evidence from the taxpayer that a different discount is appropriate. An alternative to legislation might be for Treasury to promulgate a revenue procedure detailing rules for valuation adjustments that presumptively are regarded as reasonable.

2. 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.

3. Aggregate Family and Donatively Transferred Interests. Congress could require that the value of an interest in property for transfer tax purposes should be equal to that interest's pro rata share of all interests in the property that the transferor and certain other persons hold. There are two primary approaches to aggregation available. One would require aggregation of a transferor's interest in an asset with interests in that same asset held by members of the transferor's family. The other approach would require aggregation of a transferor's interests in an

asset with interests in that same asset held by persons to whom the transferor is making or previously has made transfers, other than arms' length transfers to nonfamily members.

4. 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 entities.

5. Treat Diminutions in Net Worth as Taxable Gifts. Congress could treat diminutions in net worth as taxable gifts.

6. Coordinate the Estate and Gift Tax Valuation Rules. Congress could change the estate tax valuation rules to conform to the current gift tax treatment.

7. Simplify and Strengthen IRC §§ 2701 and 2704. 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. In addition, without the need for further statutory amendment to IRC § 2701, Treasury could permit more than the one valuation approach it describes in its regulations.

8. Establish Procedures for Resolving Valuation Controversies. 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.

## **B. Valuation of Temporal Interests in Property**

*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.

*Alternatives.* The difficulty of valuing temporal interests is an issue during the phaseout period. After repeal of the estate and GST taxes, it also remains an issue for the purpose of determining the gift tax. Therefore, the alternatives set forth below are relevant regardless of whether Congress retains the estate and GST taxes.

1. 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.

2. 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.

3. Eliminate the Exception to IRC § 2702 for Personal Residence Trusts. Congress could eliminate the exception for personal residences from IRC § 2702. If Congress determines that the special nature of a family home justifies permitting taxpayers to transfer interests during life at a

reduced gift tax cost, Congress could reduce the estate tax costs for transfers of personal residences at death.

### **§ 19. The Use of Replacement Cost for Valuation Purposes**

Issue: The use of replacement cost can lead to disparate tax results for similarly situated taxpayers.

#### *Alternatives*

1. Amend the 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.

2. Amend the 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 would realize upon the sale of the property.

### **§ 20. The Tax Inclusive Estate Tax and the Tax Exclusive Gift Tax**

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).

*Alternatives.* All of the following alternatives eliminate the difference between the tax inclusive estate tax base and the tax exclusive gift tax base, and all of them make unnecessary IRC § 2035(b), which requires an estate to include in the gross estate gift taxes paid on gifts made within three years of a decedent's death.

1. 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. The reduction of the tax base may require an increase in effective rates, if Congress wants to assure that the change is revenue neutral.

2. 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.

3. Amend IRC § 2053. Congress could amend IRC § 2053 by deleting the language "or any estate succession, legacy, or inheritance 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. The reduction of the tax base may require an increase in effective rates, if Congress wants to assure that the change is revenue neutral.

## § 21. The Deduction for Management Expenses Under IRC § 2053

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.

### *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.

## § 22. Credit for Tax on Property Previously Taxed

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 generally is true under the GST tax.

### *Alternatives*

1. 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. In the case of a recipient who dies within a short period of time after receiving a taxable gift, Congress could amend IRC § 2013 to allow the recipient's estate a credit for gift taxes paid by the transferor. In a situation in which property is subject to a GST tax within a short period of time following a transfer subject to an estate tax, Congress could amend the GST tax law to permit a credit for the estate tax to reduce the GST tax.

2. 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.

3. Repeal the Previously Taxed Property Credit. Congress could repeal IRC § 2013 and not provide a credit for previously taxed property.

4. 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. If the frequency of taxation remains a concern, Congress could provide for a tax deferral arrangement for multiple transfers to younger generations that occur within a relatively short period of time, particularly when the transfer tax applicable to the transfers is tax inclusive, such as the estate tax.

## § 23. Nontestamentary Transfers and the Gross Estate

### A. The Transferor Retains Enjoyment of and Control over Transferred Assets

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.

#### *Alternatives*

1. 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 the 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.

2. 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: (i) 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 (ii) 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.

### B. Annuities and Life Insurance

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 appreciations by their making completed lifetime gifts.

#### *Alternatives*

1. 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. If the taxpayer elects gift tax treatment, then no estate tax would be imposed on the value of the annuity at death, even though the taxpayer may have retained the right to receive payments until death or may have retained any other interest in or control over the annuity contract. If the taxpayer does not elect to treat the designation of the beneficiary as a taxable gift, then the full value of any remaining annuity amount at the taxpayer's death would be includable in the taxpayer's gross estate, in accordance with IRC § 2039.

2. 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. If a taxpayer elects gift tax treatment upon the payment of life insurance premiums, the insurance proceeds would not be subject to the estate tax at the time of the taxpayer's death. The proceeds of insurance owned by the insured, for which the insured did not elect gift tax treatment for premium payments, should be subject to the estate tax at the insured's death. Similarly, a policy owned by a third party, for which the insured paid the premiums, also should be includable in the insured's gross estate, unless during life the insured elected to treat the premium payments as taxable gifts.

### **C. Jointly Owned Property**

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 law.

#### *Alternatives*

1. 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. The transferor would make a taxable gift to the extent the transferor provides more than one-half of the consideration for jointly owned property held with one other person. That gift would be subject to taxation under the gift tax law whenever that gift was deemed to be completed under state law.

2. Repeal IRC § 2040 and Treat 100 Percent of the Value of the Jointly Owned Property as a Taxable Transfer Under the Gift Tax Law. 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. IRC § 2033 would assure inclusion of any increase in net worth attributable to the transferor's ongoing status as a joint owner, but IRC § 2040 would not apply if the transferor died before the donee and no portion of the jointly owned property would be included in the transferor's estate. In a case in which the donee dies first, Congress could require that the donee's gross estate include one-half of the value of the jointly owned interest. This rule essentially would treat the creation of jointly owned property the same as the creation of a tenancy in common. When the original transferor subsequently dies after the donee, the entire value of the property would be included in the original transferor's gross estate under IRC § 2033.

3. Allow Taxpayers to Elect Gift Tax or Estate Tax Treatment on 100 Percent of the Value of the 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. At the transferor's death, none of the jointly owned property would be included in the transferor's gross estate. If the transferor, instead, chose not to treat the creation of a jointly owned interest as a gift of the entire jointly owned property, then the entire value of the jointly owned property would be subject to estate tax at the transferor's death. The donee who received

benefits from the property would be subject to estate tax on any net worth attributable to that enjoyment, but otherwise the estate tax law would not include any portion of the joint tenancy in the donee's gross estate if the donee dies before the transferor. In addition, however, Congress would need to tax, on an annual basis as a gift from the transferor, the enjoyment element attributable to the donee's joint interest.

4. Retain IRC § 2040 and Treat 100 Percent of the Value of the Jointly Owned Property as a Taxable Transfer Under the Gift Tax Law. 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. IRC § 2001(b) would continue to reverse the consequences of the gift tax at the death of the transferor.

5. 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. Under this approach, a severance of the joint tenancy during life would result in a taxable transfer to the extent a joint tenant takes a share of the property in excess of that joint tenant's contribution. If the joint tenancy ends by reason of death, then the consideration-furnished rule of IRC § 2040(a) would apply.

## **§ 24. Payment of Estate Tax on Annuities**

*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.

### *Alternatives*

1. 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.

2. 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 estate 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.

## **§ 25. Time Extension for Payment of Estate Taxes Under IRC § 6166**

*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.

*Alternatives*

1. Adopt a Modified Universal Deferral Rule. Congress could modify IRC § 6166 by eliminating the 35 percent test while continuing to limit deferral of the estate tax to estates with illiquid assets. If Congress were to adopt this approach, it also would have to consider: (i) whether to require estates to use income to reduce the amount of unpaid tax, to the extent an estate does not use that income to pay administration expenses and interest on deferred tax; (ii) whether to consider liquid assets held in illiquid family entities as liquid; and (iii) to what extent an estate should be allowed to make distributions to beneficiaries rather than to pay tax.

2. 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. Congress could ameliorate the impact of the shorter deferral period by increasing the availability of the hardship deferral provisions of IRC § 6161. Congress also could allow an estate needing to use IRC § 6161 to qualify for deferral before the end of the three-year period. If Congress wants to discourage taxpayers from deferring payment for the three-year period, it could increase the applicable interest rates.

3. 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.

**§ 26. Qualified Family-Owned Business Interests (QFOBI)**

*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.

*Alternatives.* The EGTRRA repealed IRC § 2057 for decedents dying after 2003 but reinstates it for decedents dying after 2010. The following modifications to IRC § 2057 address the complexity of the qualification requirements that will apply after 2010.

1. 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.

2. 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.

3. 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.

4. 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.

5. 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, would not result in a recapture tax under IRC § 2057(f).

6. 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.

7. 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 a QFOBI to fund a marital deduction bequest.

## **§ 27. The Generation-Skipping Transfer Tax**

### **A. The Estate and Gift Tax Override**

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.

#### *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. The Annual Exclusion

Issue: The gift tax annual exclusion is coordinated with the GST tax for some, but not all, transfers, creating unfairness, confusion, and complexity.

#### *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 made to trusts and regardless of whether they are direct skips.

b. Allow the Annual Exclusion for Gifts Made 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 Law. Congress could adopt new requirements for the gift tax annual exclusion and coordinate the GST tax law accordingly to assure nontaxation under the GST tax law of transfers that qualify for the gift tax annual exclusion.

## 2. Credit for Tax on Property Previously Taxed

*Issue:* The estate tax law does not provide a tax credit for property previously taxed within a short period of time under the GST tax law; the GST tax law does not provide a tax credit for property previously taxed within a short period of time under the estate, gift, or GST tax law; 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 law.

### *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: (i) a generation-skipping transfer by reason of death occurs within a stated time period of a previous generation-skipping transfer, or (ii) a generation-skipping transfer by reason of death occurs within a stated time period of a previous estate or gift tax transfer.

## 3. Disclaimers

*Issue:* The transfer tax disclaimer 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.

### *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.

#### 4. Basis Adjustment for Taxable Terminations

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.

##### *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.”

#### 5. State Death Taxes

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.

##### *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. Amend the GST Tax Law to Provide for State GST Taxes on a Direct Skip. 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.

#### 6. The Estate Tax Inclusion Period (ETIP)

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.

##### *Alternatives*

a. Repeal the ETIP Rule. Congress could repeal IRC § 2642(f), which establishes the ETIP rule. The effect of the repeal would be to conform the GST tax law to the gift tax rules that determine a completed gift.

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).

### 7. Assignments of Remainder Interests

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 laws.

#### *Alternative*

Clarify the GST Tax Law to Conform to the Estate and Gift Tax Law 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 adequate and full consideration. Even without a statutory change, Treasury could achieve this result through regulations. It could adopt this rule for transfers subject to the estate or gift tax. It also could provide that, if a transfer is not subject to the estate or gift tax because the transferor received full consideration (as determined under IRC §7520, if applicable), then the GST tax would cease to apply to the devolution of the remainder interest (or the portion of the remainder interest transferred for full consideration). In addition, Treasury could revise the regulations to treat beneficiaries who sell a portion or all of their remainder interests held in trust as having received a distribution equal to the consideration received.

### 8. IRC §§ 2701 and 2702

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.

#### *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.

## **C. The GST Exemption**

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.

#### *Alternatives*

1. 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.

2. Recalculate the Inclusion Ratio After the Occurrence of Either a Taxable Distribution to Another Trust or a Taxable Termination. Congress could permit the GST exemption to eliminate the GST tax on only one taxable generation-skipping transfer.

3. 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.

4. Eliminate the Inclusion-Ratio Approach, and Permit a Trustee to Elect Which Generation-Skipping Transfers Use the GST Exemption Allocated to the Trust. Congress could eliminate the inclusion-ratio approach now in place and, instead, authorize a trustee to assign the GST exemption allocated to a trust to generation-skipping transfers. A possible modification of this alternative would be that Congress would not treat a termination of an interest of a non-skip person as a generation-skipping transfer and would impose a tax only upon a distribution to a skip beneficiary. Under this modification to the alternative, no tax would be due at the termination of the interest in the trust of the last non-skip beneficiary.

5. 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 benefit of a single beneficiary and are includable in the estate of that beneficiary.

#### **D. Direct Skips**

Issue: The problems associated with direct skips may outweigh their benefits of preventing taxpayers from avoiding the GST tax through “layering.”

##### *Alternatives*

1. Limit Generation-Skipping Transfers to Taxable Distributions and Taxable Terminations. Congress could repeal IRC § 2612(c) and not treat direct skips as generation-skipping transfers.

2. Reduce the Rate of Tax on Direct Skips. Congress could reduce the rate of the GST tax on direct skips.

#### **E. Transfers to Persons Unrelated to the Transferor**

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.

##### *Alternative*

Exclude Gifts to Nonrelatives from the GST Tax. Congress could exclude transfers to nonrelatives from the GST tax.

#### **F. Generation Assignments of Persons Unrelated to the Transferor**

Issue: If the typical generation is 25 years long, the generation assignment rules assign nonrelatives to more remote generations than they should be assigned.

*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.

**APPENDIX A**

**ALTERNATIVES TO THE CURRENT FEDERAL WEALTH TRANSFER TAX SYSTEM**

This Appendix presents three alternatives to the current federal wealth transfer tax system: (i) an accessions tax, which involves a separate tax on an individual's cumulative lifetime receipts of gratuitous transfers; (ii) an income-inclusion system, which requires the inclusion of receipts of gratuitous transfers in the gross income of a recipient; and (iii) a deemed-realization system, which treats gratuitous transfers as realization events for income tax purposes.

**APPENDIX B**

**SCHEDULED ESTATE AND GIFT TAX APPLICABLE EXCLUSION AMOUNTS  
AND THE GST EXEMPTION AMOUNT**

The EGTRRA increases the estate and gift tax applicable exclusion amounts and the GST exemption amount between 2001 and 2009. After the EGTRRA reinstates the estate and GST taxes in 2011, these applicable exclusion and exemption amounts are determined in accordance with the law in effect in 2001. Appendix B shows these scheduled increases.

