REPORT ON REFORM OF FEDERAL WEALTH TRANSFER TAXES

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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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PART III. BASIS

ABBREVIATIONS

CLAT	Charitable lead annuity trust
CRAT	Charitable remainder annuity trust
DISC	Domestic international sales company
EGTRRA	Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38
ETIP	Estate tax inclusion period
GST	Generation-skipping transfer
IRA	Individual retirement account
IRC	Internal Revenue Code
IRD	Income in respect of a decedent
IRS	Internal Revenue Service
JGTRRA	Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752
1976 BLUEBOOK	STAFF OF JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 (Comm. Print 1976)
1986 BLUEBOOK	STAFF OF JOINT COMM. ON TAXATION, 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 (Comm. Print 1987)
QDOT	Qualified domestic trust
QFOBI	Qualified family-owned business interest
QTIP	Qualified terminable interest property
SBJPA	Small Business Jobs Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755

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),[1] 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.

The Report consists of four parts and two appendixes. Part I considers issues that pertain to the phaseout 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 issues that will arise upon implementation of the modified carryover basis rule that takes effect upon repeal of the estate and GST taxes.

Part IV and Appendix A shift attention away from the EGTRRA and consider alternatives to repeal of the estate and GST tax laws. Part IV identifies issues arising under the current estate, gift, and GST tax laws and suggests alternative ways of resolving those issues within a wealth transfer tax system. As part of its discussion, Part IV indicates alternative

[1] Pub. L. No. 107-16, 115 Stat. 38.

approaches that Congress might want to adopt during the phaseout of the estate and GST taxes. Appendix A evaluates alternatives to the current wealth transfer tax system and to the repeal of the estate and GST tax laws accompanied by a modified carryover basis rule.

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.

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.

Current Law. Estate planning and drafting today is a challenge, given the scheduled changes in the law, which include increasing the applicable exclusion amounts and the GST exemption amount, declining tax rates, repeal of the estate and GST taxes, and sunset of the repeal of those taxes. A significant number of individuals likely will have estate plans with provisions that are inappropriate. Problems can arise because some individuals lack sufficient mental capacity to execute new plans. Others will not change their plans because they are hopeful that death will not predate permanent repeal, are reluctant to incur the expenses associated with executing multiple estate plans in response to the changing tax climate, are remiss in making needed changes, or have estate planners who inadequately have assessed their existing documents and how they might apply as the tax law changes.

The Internal Revenue Code (IRC or Code) generally does not provide for postmortem corrections of estate plans, even if the reason for reformation is a mistake by a drafter or a change in the tax laws. The qualified disclaimer rules in IRC §§ 2518, 2046, and 2654(c) do not correct planning mistakes; instead, they try to ameliorate the impact of those mistakes by rejecting portions of the plan itself. The Code has authorized postmortem reformation in a limited number of instances, namely, IRC § 2055(e)(3), having to do with charitable split interest trusts; Treas. Reg. § 20.2056A-4, having to do with qualified domestic trusts; and Treas. Reg. § 25.2702-5(a)(2), having to do with qualified personal residence trusts.

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.[2] 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. What this alternative would acknowledge is that the doctrine of reformation, especially in view of the scheduled changes in

[2] *See, e.g.*, UNIF. TRUST CODE §§ 415 (reformation to correct mistakes), 416 (modification to achieve a settlor's tax objectives).

tax law, can operate in a manner that respects and furthers the integrity of the law and does not lead to artifice by planners.

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.[3] 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 without the qualified transferor incurring federal gift tax liability.[4] 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.

Current Law. The lengthy phaseout period, as well as the decoupling of the estate and gift taxes on January 1, 2004, create significant transition issues. The phaseout of the estate and GST taxes and the one-year repeal that follows cause many taxpayers and their advisers to question whether repeal will ever occur. Several congressional and presidential elections will take place during the phaseout period. That political reality has the effect of increasing the risk that a future Congress, which may be composed of new members and new leadership and which is likely to face different challenges than the Congress that approved repeal, will delay or eventually revoke the repeal.

1. Financial and Estate Planning. The lengthy phaseout period causes complexity and uncertainty as taxpayers engage in financial and estate planning. The scheduled changes to the estate and gift tax applicable exclusion amounts, which can be found in Appendix B, and the one-year repeal of the estate tax in 2010, make estate planning difficult and expensive. For example, some individuals may want to acquire or maintain life insurance only if their estates will incur an estate tax liability, but they have no way of knowing whether their estates will, in fact, owe estate taxes.

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[3] British law has adopted this type of approach. Inheritance Tax Act, 1984, c. 51 (Eng.).

[4] The qualified transfer alternative would not be necessary if Congress were to permit a gift tax and a GST tax credit for property that has incurred a previous wealth transfer tax within a short period of time. The qualified transferors typically would make a qualified transfer soon enough so that a credit for the original transferor's taxable transfer would eliminate any tax liability for the qualified transferors. For further discussion of an alternative to expand the scope of IRC § 2013, having to do with an estate tax credit for property previously subject to an estate tax, beyond the estate tax, see *infra* § 22.

Another example involves planning for owners of closely held businesses. Some entrepreneurs may believe that their businesses could not survive after they die, if the businesses were to have to bear the burden of a substantial estate tax. Therefore, they may contemplate a lifetime sale of their businesses in order to maximize the price that they might receive and avoid a forced sale by their heirs to pay an estate tax liability. This decision becomes significantly more difficult in the context of an uncertain tax climate.

The uncertainty about the estate tax affects business owners' plans for succession in yet another way. The possibility that there will be no estate tax may discourage individuals from making gifts of a portion or all of their businesses. The fact that the EGTRRA limits the applicable exclusion amount for gifts to $1 million while the estate tax's applicable exclusion amount increases up to $3.5 million in 2009 further discourages planning for business succession through lifetime gifts.[5] Yet another reason why the EGTRRA discourages business owners from planning for succession through lifetime giving is that the donees of interests in closely held businesses will take only a carryover basis under IRC § 1015. If a business has appreciated in value from the time the owner acquired it, the carryover basis provided under IRC § 1015 compares unfavorably with the basis determined by the business's fair market value at the death of that owner under IRC §1014, which would apply if that owner were to die before 2009 or after 2010. It also may compare unfavorably with the modified carryover basis provided under IRC § 1022, which would apply if the business owner were to die in 2010.[6]

Another aspect of planning that becomes more complex, especially for married couples, involves the drafting and operation of formula clauses. Wills and revocable trusts typically use formulas that take into account the applicable exclusion amount. While such formulas work well when the applicable exclusion amount is stable or increasing slowly, large abrupt changes can wreak havoc on dispositive plans, as the following example demonstrates.

> *Example: A decedent dies with an estate of $3 million. G* owns a $3 million estate and has a will that leaves "the smallest amount that will result in no estate tax" to her husband. If she dies in 2004, her husband would receive $1.5 million. If she dies in 2006, her husband would receive $1 million. If she dies in 2009 or 2010, he would receive nothing under *G*'s will. If she dies in 2011, her husband would receive $2 million of her estate.[7]

The recurring large changes in the applicable exclusion amount require taxpayers either to make frequent changes to their estate plans or to provide alternate dispositive patterns, depending on the amount of the applicable exclusion at death and whether the taxpayer dies when the federal estate tax is in effect. In either case, estate planning becomes more complex and costly. For taxpayers who become incapacitated during the phaseout period and, therefore, are precluded from making changes in their estate plans, the problems, complexities, and costs of the long phaseout period are even greater. In sum, in this uncertain tax environment, those requiring estate planning advice face many potential planning traps and those providing estate planning

[5] IRC §§ 2505, 2510. For further discussion of the decoupling of the estate and gift tax applicable exclusion amounts, see *infra* §§ 2.2 and 5.
[6] For further discussion of a comparison of IRC §§ 1015, 1022, and 1014, see *infra* § 7.
[7] IRC §§ 2010, 2210(a).

advice are left offering their clients complex, expensive, and often unsatisfactory interim solutions.[8]

2. Decoupling of the Estate and Gift Taxes. The planning difficulties are compounded because the EGTRRA decouples the estate and gift taxes in 2004 and continues the gift tax after repeal of the estate and GST taxes. During a six-year period from 2004 through 2010, the amount that transferors can transfer tax free during life is substantially less than the amount that they can transfer tax free at death.[9] In addition, the prospect of no estate tax in 2010 may make individuals, who have as their primary motivation for making lifetime transfers potential estate tax savings, reluctant to take advantage of gifts that qualify for the annual exclusion or gifts that avoid taxation because of the applicable exclusion amount. A donor's making of both nontaxable and taxable gifts often reflects prudent tax planning in the face of a future estate tax. A decision to make a taxable gift in the absence of an estate tax, however, becomes sensible only when the nontax benefits to the donee outweigh the donor's gift tax costs.[10]

3. The GST Tax. The prospect of repeal of the GST tax in 2010 is likely to affect current estate plans, because it changes the tax benefits transferors obtain when they make gifts to their children rather than to their grandchildren. In addition, the repeal of the GST tax has an effect on formula clauses during the phaseout period and during the year of repeal. For example, a will or revocable trust could define a bequest to grandchildren or younger lineal descendants as that amount that would qualify for the GST tax exemption available to the decedent. The bequest will steadily increase in amount during the phaseout period. After repeal of the GST tax, that bequest decreases to zero. It may not be likely that those varying results correspond to the intention of most transferors, especially when the bequest involves lineal descendants from different marriages or relationships.

Another problem caused by the prolonged phaseout of the GST tax is that it creates a premium on taxpayers' deferring until 2010 an event that would otherwise attract a GST tax. In most cases, well-advised persons would not deliberately incur a GST tax during the phaseout period. For example, rather than making gifts to trusts for descendants on a *per stirpital* basis, transferors may prefer to use wholly discretionary trusts in order to postpone a taxable termination until 2010. Alternatively, they can avoid a taxable termination by giving a charity a nondiscretionary interest in a trust. The only thing that is predictable during the long phaseout period is that postponement of repeal of the GST tax will lead well-advised persons to engage in complicated planning that includes complex formulas.

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.

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[8] For further discussion of planning complexities and proposals for Congress to authorize reformation of estate plans, see *supra* § 1.

[9] For further discussion of Congress's rationale for decoupling the exclusion amounts applicable to the estate tax and the gift tax and not repealing the gift tax in 2010, see *infra* § 5.

[10] For further discussion of lifetime gifts and assignment of income issues, see *infra* § 5.

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.[11] 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 this tax until the end of the phaseout period. Congress could reunify the estate and gift taxes during the phaseout period and immediately repeal the GST tax, whether or not it decides to reduce the length of the phaseout of the estate tax.

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. This alternative is unrelated to the length of the phaseout period. The Report addresses this option in Part II as part of its discussion of the relationship of the gift tax to the income tax.

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. The Report considers what those modifications might be in Part IV.

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. The Report addresses these alternative tax systems in Appendix A.

§ 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.

Current Law. The EGTRRA phases out the credit for state death taxes by limiting the credit, which is found in IRC § 2011, to 75 percent of its former level in 2002, 50 percent of its former level in 2003, and 25 percent of its former level in 2004. In 2005, with the credit repealed, the Act replaces it with a deduction for state death taxes paid, which is found in IRC § 2058. These changes create planning complexity and uncertainty throughout the phaseout period.

The elimination of the state death tax credit produces a dramatic shift of revenue from states to the federal government in states that employ a so-called pickup estate tax, which is a state estate tax that conforms to the amount of the federal state death tax credit. In a state with only a pickup estate tax, the revenue from the estate tax declines by 25 percent each year until it disappears in 2005. The following example demonstrates the impact of these changes.

[11] For further discussion of reunifying the estate and gift taxes during the phaseout period, see *supra* § 2.

> *Example: Impact on the states of the phaseout of the state death tax credit. G*, who lived in a conforming state, had a taxable estate of $2.5 million when she died in 2003. Her estate owed $680,000 in total federal estate taxes.[12] Under previous law, this amount would have consisted of $541,200 in federal taxes and $138,800 in state taxes. However, the 50 percent reduction in the state death tax credit in 2003 reduced the state's share of the tax by $69,400 (50 percent x $138,800) and, correspondingly, increased the federal government's share by the same amount.[13]

Under prior law, every state, at a minimum, imposed a state estate tax equal to the state death tax credit allowed under IRC § 2011. The operation of the credit under prior law had the salutary effect of making state death tax laws more uniform, reducing the administrative burden on states to collect and enforce state death taxes, and minimizing taxpayer compliance costs.[14] With the elimination of the state death tax credit, states have little incentive to conform their estate tax laws to the federal estate tax law. Consequently, states may amend their laws to preserve revenues from state estate taxes that are measured by reference to the state death tax credit in effect prior to the enactment of the EGTRRA. While a few states, including California, Florida, and Nevada, have constitutional prohibitions against a separate state death tax or require an affirmative vote by their citizens to impose a separate tax, other legislatures already have passed laws to decouple the state estate tax from the federal system or to tie the state death tax system to pre-EGTRRA law.[15] If other states follow their lead, they, too, may decouple their estate taxes from the federal system, which may result in an increase in litigation over domicile and situs issues and additional compliance burdens and costs for taxpayers.

In most nonconforming states, estate tax relief to taxpayers from the EGTRRA is minimal before 2005 (see following table). In fact, the overall federal and state estate tax burden for taxpayers in nonconforming states may be higher in 2003 through 2005 than under prior law, based on the assumption that the scheduled increases in the applicable exclusion amount under the Taxpayer Relief Act of 1997 would have taken effect.[16]

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[12] *See* IRC §§ 2001, 2010. The progressive rate schedule of IRC § 2001(c) provides that the estate tax on a taxable estate of $2.5 million is $1,025,800, and IRC § 2010(c) provides for a unified credit of $345,800 (the amount of tax under IRC § 2001(c) for an applicable exclusion amount of $1 million), which results in a total tax liability of $680,000 ($1,025,800 – $345,800). *See* Appendix B (scheduled increases of the estate and gift tax applicable exclusion amounts).

[13] Even in conforming states, planners must consider adjusting formula clauses found in clients' documents to take into account the shift from a credit to a deduction.

[14] Even before the enactment of the EGTRRA, a number of states effectively had decoupled their wealth transfer taxes at death from the federal estate tax by tying their own to the federal state death tax credit as it was in effect in a previous year (e.g., Kansas, New York, Oregon, Virginia, Washington, and the District of Columbia) or by assessing additional inheritance taxes (e.g., Connecticut, Indiana, Iowa, Kentucky, Louisiana, and Tennessee).

[15] Pub. L. No. 105-34, § 501, 111 Stat. 788. For further discussion of post-EGTRRA state estate tax regimes, see COMM. ON EST. & GIFT TAX, A.B.A. TAX'N SEC., *A Survey of Post-EGTRRA State Estate Tax Regimes* (2003).

[16] For further discussion of federal and state wealth transfer tax burdens before and after enactment of the EGTRRA, see Ronald D. Aucutt, *Planning and Drafting Strategies After the Economic Growth and Tax Relief Reconciliation Act of 2001, in* ALI-ABA, PLAN. TECH. FOR LARGE EST. (Nov. 18–22, 2002).

Combined Federal and State Estate Tax Burden, 2001–06

Year	Maximum Gross Federal Tax Rate	Less State Credit/Deduction*	Net Federal Tax Rate	State Tax Rate in Nonconforming States	Overall Federal and State Tax Rate
2001	55%	-16%	= 39.00%	+16%	55.00%
2002	50%	-12%	= 38.00%	+16%	54.00%
2003	49%	- 8%	= 41.00%	+16%	57.00%
2004	48%	- 4%	= 44.00%	+16%	60.00%
2005	47%	-16%	= 39.48%	+16%	55.48%
2006	46%	-16%	= 38.64%	+16%	54.64%

* Credit applies 2001-04; deduction applies 2005-06.

Taxpayers may also face situations in which state estate tax is due, even though no federal estate tax is due. For example, a nonconforming state like New York recognizes an applicable exclusion amount of $1 million. Even though the federal applicable exclusion amount will increase to $2 million by 2006, a New York taxpayer dying in 2006 with an estate greater than $1 million will incur a state death tax liability.

As a result of changes in the operation of the state death tax credit and the decoupling of federal and state estate taxes, moderately wealthy taxpayers domiciled in nonconforming states will face additional planning considerations.[17] In general, if the first spouse to die funds a unified credit shelter trust by the full amount of the federal applicable exclusion, an increase in state death taxes may result. The EGTRRA may force married persons in nonconforming states to decide whether to reduce their federal estate taxes by taking advantage of increases in the federal applicable exclusion amount and, thereby, potentially pay more state taxes, or to increase their marital deduction bequests to avoid state taxes and, thereby, potentially pay more federal estate taxes at the surviving spouse's death.

The EGTRRA's changes to the state death tax credit also create problems for more wealthy taxpayers who rely on formula marital deduction bequests in their estate plans. Many estate plans use language in which a formula determines the size of the marital deduction. For example, a plan may stipulate that the executor fund the marital bequest with the smallest amount that will produce the largest possible reduction of the federal and state estate taxes that otherwise would be payable as a result of the decedent's death. In nonconforming states this language will minimize current federal and state taxes, but may result in suboptimal use of the federal estate tax applicable exclusion amount, resulting in the payment of substantially more federal estate taxes at the death of the surviving spouse. Other estate plans may use language providing for the executor to fund the marital deduction bequest to the extent required to produce

[17] Much of the following discussion is taken from Robert C. Pomeroy, *Effect of the Decoupling of State Death Taxes from the EGTRRA State Death Tax Credit on Deathtime and Lifetime Planning*, AM. C. TR. & EST. COUNS. 2003, Annual Meeting (Mar. 4–Mar. 10, 2003).

the maximum reduction in the federal estate tax, taking the state death tax into account only to the extent an increase in the state death tax does not result. In nonconforming states, this language may result in the current payment of state death taxes.

The uncertainty regarding the repeal of the estate tax compounds the difficulty of these decisions, particularly for smaller estates. If the value of the surviving spouse's estate does not exceed the federal estate tax applicable exclusion amount in effect when the survivor dies, incurring state death tax at the time the first spouse dies will have produced no benefit, especially if the surviving spouse moves to a conforming state prior to his or her death. However, even for larger estates, if the surviving spouse dies in 2010 or at some other time when Congress has repealed the federal estate tax, saving state taxes at the death of the first spouse may prove to have been prudent planning. If Congress has not repealed the estate tax at the time of the death of the surviving spouse, however, the additional federal taxes at the surviving spouse's death may dwarf the state tax savings at the time the first spouse dies.

Even without a formula clause, problems may arise. Some plans call for leaving a decedent's entire estate to a trust that meets the requirements for qualified terminable interest property (QTIP) treatment and for allowing the executor to elect QTIP treatment for all or part of the trust.[18] In these situations, an executor will have to decide whether to elect QTIP treatment for the amount necessary to eliminate only the federal estate tax, so as to save federal estate tax at the death of the surviving spouse, or to elect QTIP treatment for the amount necessary to also eliminate the payment of state estate tax at the time the first spouse dies. Upon repeal of the federal estate tax in 2010, the federal estate tax election of QTIP is not available. States can no longer depend on the federal estate tax rules and may have to modify their own laws to provide for QTIP elections.[19] A surviving spouse will face similar difficulties when the estate plan of a decedent leaves everything to the surviving spouse in a form that qualifies for the marital deduction and provides for a credit shelter trust for the portion of the estate that the surviving spouse may disclaim.

Alternatives

1. <u>Recognize a State Law's Doctrine of Reformation</u>. 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.[20]

2. <u>Reduce the Length of the Phaseout Period</u>. 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.[21]

[18] *See* IRC § 2056(b)(7).
[19] *See*, *e.g.*, Mass. Gen. Laws ch. 65C § 3A (2002) (allowing a QTIP election for state tax purposes).
[20] For further discussion of state-authorized reformation, see *supra* § 1.
[21] For further discussion of the lengthy phaseout period, see *supra* § 2.

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. The 25 percent credit allowed for estates of decedents dying in 2004 produces a 60 percent top marginal combined state and federal tax rate for those decedents who lived in nonconforming states. In 2005, the combined top marginal rate decreases to an amount close to the combined top marginal rate that was applicable in 2003. Congress could avoid this "bubble" in the death tax in 2004 by keeping the effective tax rate close to the same level that applied in 2003 until the estate tax repeal takes effect. Whether Congress retains the credit at 50 percent in 2004 or accelerates the deduction to 2004, it would accomplish approximately the same result of avoiding a 60 percent top marginal combined rate for decedents dying in 2004.

§ 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.

Current Law. The EGTRRA provides for a one-year repeal of the estate tax in 2010 and its subsequent reinstatement in 2011.[22] During the one-year repeal, the EGTRRA replaces IRC § 1014, which generally provides for a basis in a decedent's assets equal to their fair market value at the date of the decedent's death, with IRC § 1022, which provides for a modified carryover basis rule.[23] Under the modified carryover basis rule, a recipient who acquires assets from a decedent and sells them may be subject to income tax on any appreciation that occurred before the decedent's death.[24] Along with some other modification rules, IRC §1022(b)(2) provides for an aggregate basis increase of $1.3 million (indexed), and IRC § 1022(c) provides for an aggregate spousal property basis increase of $3 million (indexed). Although the EGTRRA repeals the estate tax in 2010, it continues the gift tax with a $1 million lifetime applicable exclusion amount and a top rate of 35 percent.[25] In 2011, the EGTRRA restores the estate tax.

[22] IRC §§ 2210, 2664; EGTRRA § 901.
[23] For a discussion of the modified carryover basis rule, see *infra* Part III.
[24] In 2010, the highest capital gain tax rate currently is scheduled to be 20 percent, while the top income tax rate on ordinary income will be 35 percent. IRC § 1(h)(1)(C), (i). The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), Pub. L. No. 108-27, §§ 301(a)(2), 303, 117 Stat. 752, 758, 764, reduces the highest capital gain tax rate to 15 percent for gains taken into account after May 5, 2003, but the law currently provides that the rate will increase to 20 percent once again for net capital gains recognized after 2008.
[25] EGTRRA §§ 511(f), 521.

The transfer tax law rules that were in place in 2001 apply to all wealth transfers that occur after 2010, as if Congress had never enacted the EGTRRA.[26]

A one-year repeal of the estate tax in 2010, followed by its restoration in 2011, departs from some traditional tax system principles. The uncertainty of the repeal makes planning difficult and costly. In addition, the one-year repeal introduces the possibility of significant differences in tax burdens for similarly situated taxpayers dying in different years.

The estates of unmarried decedents of $3.5 million or less would incur no estate tax in 2009, and, under IRC § 1014, each asset acquired from those decedents generally would have a basis equal to its fair market value, determined at the decedent's death. If the same decedents die in 2010, the estates would not incur any estate tax, but the recipients of the assets of those decedents may have potential income tax liability under the modified carryover basis rule of IRC § 1022, depending on the aggregate amount of unrealized appreciation of the assets. If the same decedents die after 2010, their estates would incur estate taxes to the extent they exceed $1 million in value.[27] Under IRC § 1014, generally each of a decedent's assets again would have a basis equal to the fair market value of the assets, determined at the decedent's death.

Married couples with combined assets of $7 million or less can avoid any estate tax in 2009 with proper planning, but may, like their unmarried counterparts, be subject to higher tax in 2010.[28] In 2009, each asset passing to a surviving spouse qualifies for the marital deduction and receives a basis equal to its fair market value, even though it is not subject to an estate tax. No estate tax is due in 2010, but the modifications to the basis of each asset received by a surviving spouse may not be sufficient to eliminate potential income tax liability, depending on the aggregate amount of unrealized appreciation in the assets owned by the decedent. Only married couples with combined assets of $2 million or less can avoid estate tax after 2010 with proper planning. Under IRC § 1014, a surviving spouse of such a relatively modest estate will avoid income tax on any unrealized appreciation on assets included in the estate of the decedent.

The beneficiaries of the estates of some decedents, however, will be considerably better off if the decedents die in 2010, rather than before 2010 or after 2010, as the following example demonstrates.

> *Example: A wealthy, unmarried decedent. G,* who is unmarried, dies in 2009 with a $100 million estate that he devises to noncharitable beneficiaries. His estate incurs an estate tax liability of approximately $43 million, but the recipients of *G*'s property do not have to incur any income tax liability on any unrealized appreciation that has accrued before his death.[29] If *G* were to die in 2011, the estate tax liability would be over $54 million.[30] Again, *G*'s beneficiaries would not have

[26] EGTRRA § 901.

[27] The rates in place in 2001 become effective in 2011. The applicable exclusion amount is $1 million because it was scheduled to increase to that amount, beginning in 2006, under the law in effect in 2001.

[28] The proper planning involves using trusts and asset allocations to assure that each spouse takes advantage of the unified credit applicable exclusion amount. For further discussion of planning for married couples, see *supra* § 2.

[29] IRC §§ 1014, 2001, 2010. The estate tax liability of $43,425,000 is computed as follows: Taxable estate of $100 million less $3.5 million to reflect no tax on the unified credit applicable exclusion amount, which equals $96,500,000, multiplied by 45 percent (maximum estate tax rate).

[30] The estate tax liability of $54,429,500 is computed as follows: The first $2.5 million enjoys the progressive rates provided in IRC § 2001(c) and is taxed at $1,025,800. The remaining $97.5 million is subject to tax at the 55 percent

> to incur income tax liability on any unrealized appreciation that has accrued since *G*'s death, because IRC § 1014 would apply. If *G* were to die in 2010, no estate tax would be due and, even if *G*'s beneficiaries took a basis of zero in each of the assets they received and ignored the modifications to basis available, they would have to incur a capital gain tax of only $20 million upon the sale of all the assets.[31]

The differences in tax consequences indicated in the example, which can result from a one-day (or even a one-minute) difference in the time of a decedent's death, introduce substantial equity issues. Disparate treatment also results from the determination of holding periods of assets included in the estates of decedents, depending on whether they die in 2009 or 2010. Assets inherited from a taxpayer dying in 2009 (or 2011) will have a long-term holding period under IRC § 1223(11). In contrast, assets inherited from a taxpayer dying in 2010 may include both ones with short-term and ones with long-term holding periods and can result in higher income tax assessments, if the estate or recipients of the property sell assets with short-term holding periods.[32]

The change to a carryover basis rule for the year 2010 creates a great deal of uncertainty, complexity, and increased compliance costs. Taxpayers would undoubtedly adapt over time to the necessity of maintaining basis records for all assets. Some people may begin to plan for wealth transfers under two different sets of rules and keep additional records to meet the requirements of IRC §1022. Computerization of records related to stock and mutual fund purchases and real estate investments has made basis determination easier in recent years, but taxpayers still must contend with the difficulties of determining the basis of an asset that has been held for decades. Some experts have argued that the $1.3 million aggregate basis increase and the $3 million aggregate spousal property basis increase significantly will reduce the number of estates that will have to contend with the complexities of the modified carryover basis rule of IRC § 1022, and, therefore, most people can ignore that rule in 2010. It seems unwise, however, for individuals who currently have nontaxable estates to conclude that, by 2010, they would not have accumulated sufficient assets for the modified carryover basis rule to present serious compliance issues. Recipients of property fom decedents who die in 2010 but who had not prepared for the modified carryover basis rule may face the difficult and time-consuming task of researching incomplete records to determine carryover basis. In addition, IRC § 1022(b)(2)(C)(i) introduces an adjustment to basis based on a decedent's loss carryovers, which can involve an array of complex tax issues spanning many tax years prior to a decedent's death. Recipients of a decedent's property will have the burden of proving the accuracy of those loss carryovers as an adjustment to basis.

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rate, which equals $53,625,000. The sum of the tax under IRC § 2001 is $54,650,000, which is reduced by the unified credit provided for in IRC § 2010 of $220,500 (unified credit applicable exclusion amount of $675,000).

[31] In 2010, the highest capital gain tax rate currently is scheduled to be 20 percent. IRC § 1(h)(1)(C),(i). For a discussion of the JGTRRA and the reduction of the highest capital gain tax rate to 15 percent through the year 2008, see *supra* note 24.

[32] For further discussion of holding periods, see *infra* § 7.2.

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. In either case, it 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.

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. It could provide that the election, once made, is irrevocable. 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 in 2009. It also would ameliorate the record-keeping problems created by the modified carryover basis rule. It does not, however, address the disparate tax treatment that arises from the fact that a decedent dies in 2009, rather than in 2010, or dies after 2010, rather than in 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.

Current Law. The temporary repeal and reinstatement of the GST tax create unique problems. A review of the basic rules applicable to the GST tax is useful to understand fully the nature of the issues that arise as a result of a one-year repeal of the GST tax. The GST tax is imposed at the highest estate tax rate, and it applies to gifts and bequests to, or for the benefit of, "skip persons."[33] Skip persons are: (i) individuals who are more than one generation younger than the "transferor," such as a transferor's grandchild, and (ii) trusts that benefit only skip persons.[34] A transferor is a person who makes a transfer that is subject to the gift or estate tax.[35] There are three types of generation-skipping transfers: direct skips, taxable distributions, and taxable terminations.

A direct skip is a gift or bequest to a skip person.[36] A transfer to a trust is a direct skip only if the trust is a skip person, and a trust is a skip person if the only beneficiaries with interests in the trust are skip persons.[37] Persons have interests in a trust if they have a right to receive current income or corpus or are permissible current recipients of income or corpus from

[33] IRC §§ 2612–13, 2641.
[34] IRC § 2613.
[35] IRC § 2652(a).
[36] IRC § 2612(c).
[37] IRC §§ 2612(c), 2613(a)(2).

the trust.[38] For example, a trust that directs the trustee to distribute income and corpus only to the transferor's grandchildren is a skip person.

A taxable distribution is a distribution from a trust to a beneficiary who is a skip person.[39] For example, if a transferor creates a trust for the benefit of the transferor's child and grandchildren, a distribution from the trust to a grandchild is a taxable distribution. Distributions for health care and tuition directly to the providers of services are not subject to the GST tax.[40]

A taxable termination occurs when a trust ceases to have a beneficiary who is not a skip person.[41] For example, if a transferor creates a trust for the benefit of the transferor's child and grandchildren, upon the death of the child, the trust would cease to have a beneficiary who was not a skip person and a taxable termination would occur. IRC § 2612(a)(1) postpones a taxable termination if the trust continues to have a beneficiary who is not a skip person. For example, a taxable termination does not occur in a trust for the benefit of all of the transferor's descendants until the death of the last surviving child of the transferor. The generation assignment of the transferor moves down a generation after a generation-skipping transfer occurs in order to avoid a second taxable transfer on the passing of the same property to the same generation (or to an older generation).[42] For example, if a transfer to a trust is a direct skip because the beneficiaries are the transferor's grandchildren, a distribution from that trust to a grandchild is not a taxable distribution. The reassignment of the transferor to the generation of the transferor's child prevents a taxable distribution when the trustee distributes income or corpus to a grandchild, because that grandchild is no longer a skip person, i.e., more than one generation younger than the transferor. But for this rule, there would be a taxable transfer for GST tax purposes both when the transferor funds the trust and again when the trustee makes a distribution to a grandchild.

When a taxable termination occurs, the generation assignment of the transferor also changes. For example, suppose that a transferor directs a trustee to distribute income to a child for life and, at the child's death, to distribute income to the transferor's grandchildren until the youngest attains the age of 40. When the child dies, a taxable termination occurs because the trust no longer has any non-skip person as a beneficiary. At that point, IRC § 2653(a) changes the generation assignment of the transferor to the child's generation. This change of generation assignment of the transferor prevents a second GST taxable transfer from occurring when the trustee subsequently makes distributions to the transferor's grandchildren.

A taxable transfer for GST tax purposes occurs (and the generation reassignment rule applies) whether or not the taxable transfer in fact results in a GST tax. If a GST exemption shelters a GST taxable transfer from tax, the Code nevertheless treats the taxable transfer as having occurred.[43] Each transferor is entitled to an exemption from the GST tax. In addition to sheltering the GST tax due on direct skips, the transferor or the transferor's executor also may

[38] IRC § 2652(c)(1). IRC § 2613(a)(2) also defines a trust as a skip person if there is no person who holds an interest in the trust, which is to say, no person has a right to or is an eligible recipient of a current income or corpus distribution, and a trustee could not make a distribution from the trust to a non-skip person at any time.
[39] IRC § 2612(b).
[40] IRC § 2611(b)(1).
[41] IRC § 2612(a)(1).
[42] IRC § 2653(a).
[43] IRC § 2631(a).

allocate the GST exemption to a trust to avoid the GST tax at a later date when the trustee makes distributions to skip persons or when the trust ceases to have beneficiaries who are not skip persons. In 2003, the GST tax exemption was $1.12 million.[44] Beginning in 2004, the EGTRRA set the GST exemption at the amount sheltered from estate tax by the estate tax unified credit.[45] Thus, the GST exemption increased to $1.5 million in 2004, and will increase to $2 million in 2006, 2007, and 2008, and to $3.5 million in 2009. In 2010, neither the estate tax nor the GST tax will apply, but the gift tax will continue to be applicable to lifetime transfers.[46] In 2011, the EGTRRA sunsets, so that the pre-EGTRRA GST exemption of $1 million, adjusted for inflation, will apply once again.

A transferor may elect to allocate the GST exemption to transfers in any manner. In some cases, the Code deems an allocation of the exemption as made unless the transferor elects not to allocate the GST exemption to a transfer.[47] In other cases, an allocation of the GST exemption does not occur unless the transferor elects to allocate it. The EGTRRA increases the types of situations in which the Code deems an allocation to be made unless the taxpayer elects otherwise.[48] This change in the law sunsets in 2011 with the rest of the EGTRRA.

An allocation of the GST exemption to a trust means that all or a fraction of the value of a generation-skipping transfer will be exempt from the GST tax. That is, a taxable distribution or a taxable termination with respect to a wholly exempt trust does not result in any GST tax. In the above example, upon the death of the transferor's child, when the grandchildren's interests become possessory, there is no GST tax if the trust is wholly exempt from GST tax. The inclusion ratio is one minus the applicable fraction.[49] The numerator of the applicable fraction is the amount of the GST exemption allocated to the trust. The denominator of the applicable fraction is the fair market value of the property held in trust when the allocation of the GST exemption becomes effective, reduced by certain adjustments.[50]

Allocation of the GST exemption to trusts is not effective until the expiration of the estate tax inclusion period (ETIP).[51] The ETIP is the period of time in which, if the transferor died, the trust would be included in the gross estate of the transferor (or of the transferor's spouse, in most cases). For example, if a transferor creates a trust and retains an income interest in the trust for a term of five years, IRC § 2036(a)(1) would include the principal of the trust in the transferor's gross estate for federal estate tax purposes in the event the transferor were to die during the five-year term. IRC § 2642(c) precludes that transferor from allocating GST exemption to the trust until the expiration of the five-year term. At that time, the ETIP closes and the transferor can

[44] IRC § 2631(a), (c).
[45] EGTRRA § 521(c)(2) amends current IRC § 2631(c) to read: "For purposes of subsection (a), the GST exemption amount for any calendar year shall be equal to the applicable exclusion amount under section 2010(c) for such calendar year." *See* Appendix B (scheduled increases of the estate and gift tax applicable exclusion amounts and the GST exemption amount).
[46] For further discussion of the gift tax, see *supra* § 2.2 and *infra* § 5.
[47] *E.g.*, IRC § 2632(b)(3).
[48] IRC §§ 2632(c), 2642(g)(2).
[49] IRC § 2642(a)(1).
[50] IRC § 2642(a)(2).
[51] IRC § 2642(f).

then allocate the GST exemption to the trust. The applicable fraction and inclusion ratio are based on the fair market value of the trust assets determined at the end of the ETIP.

The EGTRRA made a number of technical changes in the GST rules having to do with the GST exemption. One is designed to avoid the imposition of a GST tax due to a failure to allocate the GST exemption properly.[52] Another prevents the imposition of a GST tax in the event of an unnatural order of deaths, such as when a child predeceases a parent.[53] These technical changes will sunset with the rest of the EGTRRA in 2011.

The repeal of the GST tax in 2010 and its restoration in 2011 make it difficult to determine how to apply the GST tax rules to trusts that are in existence in the years in which these changes occur. Below are some examples of the problems created by the one-year repeal and subsequent restoration of the GST tax that had been in effect in 2001.

> *Example 1: A gift to a trust for grandchildren in 2010.* In 2010, *G* makes a gift to a trust for the benefit of her grandchildren. If the GST tax had been in effect, a transfer to a trust that benefited only grandchildren would have been a direct skip. If the trustee had subsequently made any distributions from the trust to the grandchildren, they would not have been taxable distributions, because IRC § 2653(a) would have reassigned *G* to her child's generation. It is uncertain whether the rule reassigning the generation of *G* would apply in 2010, even though the EGTRRA repeals the GST tax for 2010. If not, when the EGTRRA restores the GST tax and the trustee makes distributions to *G*'s grandchildren after 2010, those distributions may be taxable in the absence of a provision expressly excluding from the GST tax trusts or portions of trusts that transferors funded when the GST tax was not in effect. Transferors will be able to avoid a taxable distribution, or the risk of a taxable distribution, after 2010, if they make outright gifts to grandchildren rather than gifts in trust in 2010.

> *Example 2: A gift to a trust for children and grandchildren in 2010.* In 2010, *G* makes a lifetime gift to a trust for the benefit of his children and grandchildren. If the GST tax had been in effect in 2010, a transfer to a trust that benefited both *G*'s children and grandchildren would not have been a direct skip and no generation-skipping taxable transfer would occur at the time *G* creates the trust. Consequently, the rule reassigning *G* to his child's generation would not have applied. The GST rules, however, would have allowed *G* to allocate his GST tax exemption to the trust.[54] If a taxable distribution or taxable termination occurs after 2010, after the EGTRRA restores the GST tax, it is uncertain whether the GST tax would apply. If the GST tax is not in effect in 2010, it is unclear whether there is any GST exemption to allocate. If gifts made in 2010 to trusts that are skip persons will benefit from the rule reassigning the transferor's generation, but gifts made to trusts that are not skip persons will be subject to GST tax after 2010, then a strong incentive arises to establish trusts in 2010 that disinherit the older generation beneficiaries, i.e., the transferor's children.

> *Example 3: A comparison between lifetime gifts and bequests to a trust in 2010.* In 2010, *G* makes a lifetime gift to a trust for the benefit of her children and grandchildren. *G* is a "transferor" under the GST tax law, because the transfer to the trust is a taxable gift.[55] Therefore, when the EGTRRA restores the GST tax in 2011, no problems arise in determining whether a taxable event occurs with respect to the trust. In contrast, if *G* creates a trust for her children and grandchildren by

[52] IRC § 2642(g).
[53] IRC § 2632(d).
[54] IRC § 2632(a).
[55] IRC § 2652(a)(1)(B).

bequest at her death in 2010, *G* is not a "transferor" for GST tax purposes, because the result of the repeal of the estate tax in 2010 is that the trust has no transferor.[56] Under the statute, a transferor is necessary for making generation assignments, which in turn is necessary to determine if a taxable transfer occurs. Therefore, no GST taxable event seemingly can occur after 2010 with respect to a trust created at the transferor's death in 2010, even though the EGTRRA restores the GST tax in 2011. The difference in the treatment of trusts funded in 2010 by gifts and those funded in 2010 by bequests is difficult to rationalize.

Example 4: Transfers from a GST trust in 2010. Sometime before 2010 when the GST tax was in effect, *G* created a trust. In 2010, the trustee makes a distribution to a skip person outright and outside of the trust. The GST tax is not in effect in that year and, therefore, presumably no GST tax liability arises, even though *G* created the trust when the tax was in effect. If, instead of making an outright distribution to an individual who is a skip person, the trustee makes a distribution to a trust for the sole benefit of skip persons, it is unclear whether a subsequent distribution from that trust after 2010 would be subject to the GST tax or whether the distribution to a skip-person trust would cause the generation assignment of the transferor to change, even though the GST tax did not exist when the trustee made the distribution to the skip-person trust. As a matter of horizontal equity, if no GST tax arises when, in 2010, a trustee makes an outright distribution to an individual who is a skip person, then no GST tax should arise either when, in 2010, a trustee makes a distribution to a skip-person trust or when the trustee of the skip-person trust subsequently, after 2010, makes an outright distribution to an individual who is a skip person.

Example 5: A "taxable termination" in a GST trust in 2010. Sometime before 2010 when the GST tax was in effect, *G* created a trust. In 2010, an event occurs that otherwise would be a taxable termination.[57] The taxable termination in turn would have caused *G*'s generation assignment to change to his child's generation.[58] Therefore, any distributions to *G*'s grandchildren after the taxable termination would not have been subject to the GST tax. It is unclear whether there would be a generation reassignment if the event that resulted in a taxable termination takes place in 2010. If not, a transferor will have a strong tax incentive to provide that the trust terminate in 2010 and to direct the trustee to distribute all of the assets to individuals who are skip persons.

Example 6: Operation of the ETIP rule. Sometime before 2010 when the GST tax was in effect, *G* created a trust. The ETIP rule prevented allocation of the GST exemption to the trust up until 2010.[59] In 2010, when the estate tax is not in effect, there is no ETIP because *G*'s death would not cause inclusion in her gross estate. It is unclear whether, if there is any GST exemption to allocate in 2010, *G* could allocate it to that trust due to the close of the ETIP. Further, it is unclear whether the trust's inclusion ratio would change, if, after *G* allocates the GST exemption in 2010, the trust again is subject to inclusion in *G*'s estate after 2010.

Example 7: Change in the amount of the GST exemption. In 2009, *G* creates a trust and allocates $3.5 million of his GST exemption to the trust. After 2010, the GST exemption decreases to $1 million (adjusted for inflation). It is unclear whether the trust's inclusion ratio would change.

Example 8: Operation of the ETIP rule when the amount of the GST exemption changes. In 2009, *G* creates a trust that is subject to the ETIP rule, preventing an allocation of GST exemption from taking effect in that year. It is unclear whether *G* could allocate her $3.5 million GST exemption to take effect when the ETIP ends. It is also unclear, if the GST exemption is less than $3.5 million when the ETIP ends, how the inclusion ratio would be determined.

[56] IRC § 2652(a)(1)(A).
[57] IRC § 2612(a).
[58] IRC § 2653(a).
[59] IRC § 2642(f).

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. 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. Alternatively, Congress could allow transferors who make lifetime gifts in trust in 2010 to allocate the GST exemption to the trusts in 2010. An allocation of the exemption would not seem to be necessary for deathtime transfers made to trusts because the absence of a "transferor" as defined under the GST tax law presumably precludes imposing the GST tax on such trusts. Congress could clarify whether the GST tax applies to deathtime transfers made in trust from 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 the GST exemption to the trust in 2010.

Congress also could provide that, in 2010, the GST tax continues to apply for the sole purpose of reassigning the transferor to a younger generation. The generation reassignment would apply upon the occurrence of an event that would have caused a direct skip to a trust, a taxable distribution from a trust to a skip-person trust, or a taxable termination under the GST tax law. This change would relieve the pressure in 2010 for individuals to make outright gifts, deathtime transfers, and trust distributions for tax reasons.

Congress further could allow a transferor to allocate the GST exemption to a trust in any year, even if the allocation cannot take effect immediately due to the ETIP rule. It also could allow that allocation to establish the trust's inclusion ratio, even if the GST exemption subsequently decreases. If Congress decides to retain the ETIP rule, it could statutorily provide that the ETIP does not close during the time that the EGTRRA repeals the estate tax. Continuation of the ETIP rule in 2010 will prevent the administrative problems that would arise if the estate tax law, in fact, includes a trust in the transferor's gross estate. That cannot occur under existing law and, therefore, there are no existing rules and procedures to govern this situation.

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. 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 the EGTRRA.

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.

Current Law. The EGTRRA does not repeal the gift tax. It increased the gift tax applicable exclusion amount to $1 million in 2002. It neither indexes that amount nor provides for the exclusion to increase in subsequent years. The exclusion of $1 million applies in 2010 and thereafter.[60] Thus, the EGTRRA provides that, in 2009, the estate tax applicable exclusion amount will be $3.5 million, while the gift tax exclusion amount will remain at $1 million.[61] Through 2009, the highest marginal tax rate for gifts will be reduced in the same manner that the Act reduces the rates for the estate tax, which by 2009 will be 45 percent. In 2010, the highest gift tax rate will be further reduced to 35 percent, which, in that year, will be the highest marginal income tax rate for individuals. In 2010, the 35 percent rate becomes a flat tax rate for any gifts in excess of the $1 million applicable exclusion amount.[62] Thus, the EGTRRA's treatment of lifetime gifts during the phaseout period of the estate and GST taxes and after their repeal has both income tax and estate tax implications.

1. Protection of the Income Tax. The circumstances surrounding the enactment of the EGTRRA indicate that Congress has retained the gift tax and limited the applicable exclusion amount to $1 million during the phaseout period to protect the income tax. One of Congress's concerns apparently is that, in the absence of a gift tax, U.S. taxpayers may make tax-free gifts of low basis or income-producing assets to U.S. donees who are in a more favorable tax position than the donor, with the expectation that the donees will subsequently return the property or proceeds to their donors after they have realized the income or gain.[63] Presumably, an additional

[60] The applicable exclusion amount remains $1 million even after the EGTRRA sunsets in 2011, because the law in effect in 2001 already had provided that the exclusion amount would increase to $1 million beginning in 2006.
[61] For further discussion of the decoupling of the estate and gift taxes, see *supra* § 2.2.
[62] IRC § 2502 (as amended).
[63] Gifts of appreciated capital assets to low-income, domestic donees would allow those donees to realize capital gains at a potentially lower rate than would have applied to the donors. For gains taken into account after May 5, 2003, the capital gain rates are 5 percent for single taxpayers with taxable income not exceeding $28,400 and for married taxpayers filing jointly with taxable income not exceeding $47,450. JGTRRA § 301(a)(1) (amending IRC § 1(h)(1)(B)). The 5 percent capital gain rate drops to zero in 2007. JGTRRA § 301(a)(1). The capital gain rate is 15 percent for taxpayers who have income in excess of these amounts. JGTRRA § 301(a)(2) (amending IRC § 1(h)(1)(C)). The capital gain rate reductions under the JGTRRA expire at the end of 2008, which means that the rates will return to 10 percent and 20 percent for net capital gains recognized after 2008. JGTRRA § 303. For further discussion of these rate reductions, see *supra* note 24.

concern is that the absence of a gift tax may encourage taxpayers to enter into abusive transactions, such as using intermediaries, that would match persons holding capital assets with unrealized gains with persons who have realized or unrealized capital losses.[64]

If, in fact, transferors exact express or implied promises from their transferees to return the assets or the proceeds from their sales, the transfers are not gifts. The law would treat these transfers as illusory and consider the transferors as the continuing owners of the assets or proceeds for tax purposes, meaning that the attempts to assign income would fail. Alternatively, the law would treat the transferors as having sold their appreciated assets at the time of the transfers; again, the attempts to assign income would fail.

2. Effect on Estate Planning. The EGTRRA negatively affects estate planning by providing, during the phaseout period, for a lower applicable exclusion amount for the gift tax than for the estate tax and for a continuation of the gift tax after repeal of the estate and GST taxes. Lifetime gifts in excess of gifts qualifying for the annual exclusion and the applicable exclusion amounts are unlikely. Instead, taxpayers are likely to engage in complex lifetime and testamentary planning to avoid the gift tax. For example, they will have an incentive to create long-term, multigenerational trusts upon their deaths, so that their beneficiaries can avoid further gift taxation on successive generations.[65] In sum, from an estate planning perspective, the EGTRRA's treatment of lifetime gifts may conflict with Congress's goal of estate and GST tax repeal—the transfer of wealth tax free.

In the absence of an estate tax, the retention of the gift tax frequently may discourage gifts among family members.[66] Historically, the gift tax has been less expensive than the estate

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The $1 million applicable exclusion amount for single donors and the $2 million exclusion amount for married donors who elect split-gift treatment under IRC § 2513, when combined with the low taxable income amount needed for taxpayers to enjoy the lower capital gain rate of 5 percent, suggests that, in many instances, the gains from tax-free gifts will likely place the donees in the higher capital gain tax bracket of 15 percent. In light of the relatively flat rate schedule for capital gains under current law, the opportunity for tax avoidance through assignment of capital gains seems minimal. The JGTRRA taxes dividend income at the same rate as capital gains, which means that the same narrow rate brackets described for capital gains apply to dividends. JGTRRA § 302(a), amending IRC § 1(h). The capital gain treatment of dividends applies to taxable years beginning after 2002 and beginning before 2009. JGTRRA §§ 302(f)(1), 303.

Assignment of capital gains and ordinary income may remain a concern for a number of reasons beyond the issue of relative tax rates. First, there may be room for abuse if donees have substantial realized or unrealized capital losses to offset the capital gains incurred upon the sale or other disposition of appreciated property that they have received by gift. Second, there are income tax provisions, such as attribution rules, that transferors may be able to avoid through lifetime gifts.

[64] The potential significant effect on state income tax revenues caused by the repeal of the gift tax is beyond the scope of the Report.

[65] The EGTRRA's treatment of lifetime gifts, therefore, further encourages the current trend of states to repeal the rule against perpetuities. *See* Note, *Dynasty Trusts and the Rule Against Perpetuities*, 116 HARV. L. REV. 2588, 2590 (2003).

[66] The differences in the carryover basis rules of IRC § 1015, which applies to lifetime gifts; IRC § 1014, which applies during the phaseout period and allows a basis equal to fair market value at the decedent's death; and IRC § 1022, which applies during repeal and allows increases to a decedent's carryover basis that are not otherwise available for lifetime gifts, also are likely to discourage gifts among family members. For further comparisons of lifetime and deathtime transfers, see *infra* § 7.

tax in many planning contexts.[67] That policy minimized interference with intrafamily transfers. It also had the beneficial effect of encouraging business owners to use lifetime gifts, as they plan for intergenerational succession of management and control of their business enterprises.[68] The EGTRRA reverses this tax policy and frequently makes lifetime gifts more expensive, with the consequence of its discouraging business succession planning and encouraging family wealth to remain "locked in" older generations, as owners delay intergenerational transfers until death.

3. Compliance Costs. The EGTRRA's treatment of gift taxes relative to its treatment of estate and GST taxes is likely to create significant administrability issues. With repeal of the estate and GST taxes, the question arises whether a transfer tax enforcement and regulatory infrastructure can be cost-effective. If repeal of the estate and GST taxes leads to a significant weakening of the transfer tax enforcement and regulatory infrastructure, the absence of effective guidance and proper enforcement of the gift tax may foster the use of "audit-lottery" techniques by aggressive taxpayers. Gift tax valuations often may be aggressive and could require the Internal Revenue Service (IRS) to expend substantial resources to contest them.[69] A further danger of continuing a tax with a weakened tax enforcement and regulatory infrastructure is that it can undermine taxpayers' confidence in the tax collection system as a whole and create an atmosphere that encourages noncompliance under the income tax as well.

Alternatives. The alternatives set forth below 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 the gift tax law in the absence of estate and GST taxes prompt the development of alternatives that rely on the income tax law 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 intrafamily 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, is to tailor the alternatives carefully to the specific potential abuses.

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. The income tax compliance rules seem to be sufficiently robust to target and prevent a

[67] For example, before 1977, the gift tax rates were less than the estate tax rates. Internal Revenue Code of 1954, ch. 736, §§ 2001 (estate taxes), 2502 (gift taxes), 68A Stat. 3, 373-74, 403-04 (1954), *repealed by* the Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001, 90 Stat. 1525, 1846 (1976). After 1976 and the unification of the applicable exclusion amounts and rate schedule, the tax exclusivity of the gift tax makes lifetime gifts made more than three years before death more attractive than deathtime transfers, which have a tax inclusive tax base. *See* IRC § 2035(b). For further discussion of the tax exclusivity of the gift tax, see *infra* § 20. Valuation rules also frequently favor lifetime giving. For further discussion of the valuation rules, see *infra* § 18. The annual exclusion also serves to encourage lifetime giving. For further discussion of the annual exclusion, see *infra* § 16.

[68] For further discussion of the effect of the gift tax on closely held businesses, see *supra* § 2 and *infra* § 7.2.

[69] For further discussion of valuation issues under the gift tax, see *infra* § 18.

transfer that does nothing more than "park" assets with a transferee who has a more advantageous tax position than the transferor.[70] This is true whether the expectation of transferors is that their transferees will return the assets directly back to them or the transferees will indirectly benefit their transferors by their giving the property to persons the transferors want to benefit.

The current tax law's approach to agency relationships provides the basis for attacking these "parking" transactions. If agency rules apply, the law would treat the transferor as the owner of the asset for all income tax purposes, including attribution and source rules and characterization questions. In other words, the law would treat the transferor as not having transferred the asset in the first place. Although no further legislation is necessary, it would be helpful for Treasury to issue guidelines establishing the parameters of an "antiparking" policy. Those guidelines could include a *de minimis* rule allowing donors to make annual gifts of assets, which, when aggregated, have a relatively low value, without risking application of the agency relationship rules. The guidelines could also allow taxpayers to avoid the application of the agency relationship rules, if they demonstrate that their transfers are not for the purpose of avoiding income tax. This exception has the advantage of minimizing interference with transfers that promote the orderly succession of wealth between generations.

2. <u>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</u>. 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. This exception corresponds to the current rule under IRC § 267, which denies losses with respect to transactions between related taxpayers. If the donor elects to be treated as the owner, the donor would retain that status for income tax purposes until the donee sells or otherwise disposes of the property, the donor dies, or the donor elects to treat the property as being sold at its then fair market value. Although this approach would determine the tax on a disposition of the asset by the donee as if the donor had disposed of it, the donor should have a right of reimbursement from the donee for any taxes paid by the donor. Its advantage is that it does not require the government to inquire into the question of whether the donor expects the transferee to return, either directly or indirectly, the proceeds from the disposition of the previously transferred assets.

3. <u>Repeal the Gift Tax and Tax a Donee's Disposition of an Asset Acquired by Gift at the Highest Applicable Tax Rate</u>. 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

[70] An example of an area in which the IRS has employed the agency theory involved installment sales between related parties. Although Congress subsequently addressed this issue by statute in IRC § 453(e), this litigation remains relevant for considering the factual inquiry as to whether an agency relationship exists between a transferor and a transferee. *See, e.g.*, Rushing v. Commissioner, 441 F.2d 593 (5th Cir. 1971), *aff'g*, 52 T.C. 888 (1969) (taxpayer prevailed); Nye v. United States, 407 F. Supp. 1345 (M.D.N.C. 1975) (taxpayer prevailed); Wrenn v. Commissioner, 67 T.C. 576 (1976) (government prevailed).

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.

Congress could adopt two other exceptions to the rule. First, Congress could provide a *de minimis* rule allowing donors to make annual gifts of assets that, when aggregated, have a relatively low value without subjecting subsequent dispositions of those assets at a gain to the highest tax rates. Second, Congress could allow taxpayers to avoid the highest tax rates upon dispositions of the assets by their demonstrating that the transfers were not for the purpose of avoiding the income tax.

This approach would discourage "parking" by eliminating the tax rate advantage. As is true of the election alternative, this approach has the advantage of not requiring the government to inquire into the question of whether the donor expects the donee to return, either directly or indirectly, the proceeds from the disposition of the previously transferred assets. The disadvantage is that it would allow taxpayers to have the benefit of transferees' lower income tax brackets for the income generated by the transferred property, as well as other attribution and source rules. A further disadvantage is that it applies regardless of whether the transferor had an expectation that the transferee would return the proceeds, either directly or indirectly.

4. <u>Retain the Gift Tax Accompanied by a Grantor Trust Election</u>. Congress could retain the gift tax but allow donors to avoid the gift tax, if they elect grantor trust treatment.[71] This proposal is an expansion of the approach Congress adopted under the EGTRRA in which it provided in IRC § 2511(c) that, effective after 2009, transfers made 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. Congress intended this amendment to prevent taxpayers from shifting income without being subject to the gift tax. Both IRC § 2511(c) and the election proposal represent the principle that, so long as the income tax law treats a donor as the owner of property that the donor has otherwise transferred, the law should not impose a gift tax. 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.[72] The advantage of the election proposal is that it simplifies estate planning by placing lifetime and deathtime transfers on an equal footing during the phaseout period and after repeal of the estate tax. If Congress wants to eliminate further the distinction between a lifetime transfer of property to a trust treated as owned by the donor and a deathtime transfer of property, it also could permit IRC § 1014 to apply to determine the basis of the assets in the trust up until 2010 and IRC § 1022 to apply in 2010.[73]

5. <u>Retain the Gift Tax with Modifications to the Annual Exclusion and Valuation Rules</u>. 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

[71] *See* IRC §§ 671–679.
[72] *Cf.* IRC § 2056A(b)(3)(A) (having to do with the exclusion from estate taxation of the distributions of income from qualified domestic trusts).
[73] For further discussion of a comparison between IRC §§ 1015 and 1022, see *infra* § 7.2.

and other valuation techniques applicable only for transfers that do not have as their sole purpose income tax avoidance. A taxpayer's ability to transfer assets either tax free by virtue of the annual exclusion or with minimal gift tax costs by virtue of the use of valuation discounts and other valuation techniques may limit the effectiveness of the gift tax to prevent income tax avoidance.[74] Congress could adopt the modifications to the annual exclusion and valuation rules in addition to its allowing a donor to elect grantor trust treatment, rather than gift tax treatment.

6. Include Form 1040 Questions. To assist in the enforcement of any of the five preceding proposals, the Internal Revenue Service (IRS) could include on Form 1040 a version of the following three questions:

> i. Has the taxpayer during the tax year made any direct or indirect transfer or transfers of property in excess of $X, other than cash, without adequate and full consideration? If so, attach a schedule of all such transfers with a value in excess of $X.
>
> ii. Has the taxpayer during the tax year made any direct or indirect transfer or transfers of property without adequate and full consideration, subject to any arrangement or understanding that the property transferred will be directly or indirectly returned to the taxpayer?
>
> iii. Has the taxpayer during the tax year received any property without full and adequate consideration that constitutes the direct or indirect return of the property, or any portion of the property, previously transferred by the taxpayer?

The reliance on voluntary compliance corresponds to the income tax system's general approach.

§ 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.

Current Law. The circumstances surrounding Congress's enactment of the EGTRRA indicate that Congress has retained the gift tax and limited the gift tax applicable exclusion amount to $1 million during the phaseout period to protect the income tax. One of its concerns apparently is that, in the absence of a gift tax, U.S. taxpayers may make tax-free gifts of low basis or income-producing assets to non-U.S. donees. The risk of revenue loss would seem to be significantly greater for transfers to non-U.S. transferees than to U.S. transferees, because non-U.S. transferees are able to recognize income or gain without the imposition of any U.S. tax upon the sale or other disposition of appreciated capital assets that U.S. donors give to them. Further,

[74] The concerns raised in the text about the annual exclusion and valuation discounts and other valuation techniques focus on how Congress could effectively use the gift tax to protect the income tax. For further proposals concerning the annual exclusion, see *infra* § 16. For further proposals concerning the valuation rules as they affect estate planning and wealth transfer taxes, see *infra* § 18.

gifts of income-producing assets do not result in U.S. income taxation to non-U.S. donees if: (i) the resulting income is non-U.S.-source income; (ii) the donees, through a tax-free disposition, convert the assets into ones that generate non-U.S.-source income; or (iii) a treaty or U.S. tax law otherwise exempts the income from U.S. tax. If the gifts of assets produce U.S. source income, they may, depending on the applicable bilateral treaties, raise less of a problem, because the income may be subject to withholding rules. Although transfers by U.S. taxpayers to non-U.S. transferees could undermine the federal income tax, that would seem to be the very situation in which transferors would be the least willing to make transfers to unrelated transferees on a mere expectation of retransfer.

Alternatives. The questions for Form 1040 described above would also assist in the enforcement of the following alternatives.[75] If Congress decides to retain the gift tax and not adopt any of the following alternatives related specifically to transfers that involve non-U.S. persons, it may want to consider the alternatives set forth above in which Congress could give the donor the right to elect grantor trust treatment and could limit the availability of the annual exclusion or valuation discounts and other valuation techniques.[76]

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. The regulations for transfers to non-U.S. transferees could be similar to the ones described earlier for U.S. transferees.[77]

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. IRC § 684 requires recognition of gain on the transfer of appreciated property by a U.S. taxpayer to a "foreign estate or trust." The EGTRRA has amended this section, effective after 2009. As amended, IRC § 684(a) extends the recognition rule to transfers to a "nonresident alien." As amended, it also makes an exception for any "lifetime transfer to a nonresident alien."[78] If Congress were to remove the exception and accelerate the effective date of the Act's amendment to coincide with the phaseout of the estate and GST taxes, it could prevent the assignment of capital gains to non-U.S. transferees. 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 the application of the realization rule of IRC § 684.

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.

[75] *See supra* § 5.
[76] *See infra* §§ 16, 18.
[77] *See supra* § 5.
[78] IRC § 684(b)(2).

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. Congress could adopt this rule in addition to its expanding the application of IRC § 684. This alternative would rely on the current reporting provisions of IRC § 6039F, which requires U.S. transferees to report large gifts they receive from non-U.S. transferors. From a compliance perspective, the failure to report incoming gifts should be no more likely than the failure to file gift tax returns. Taxpayers may still have an incentive to engage in offshore transfers of property, because the income taxation of inbound gifts allows for tax-free deferral of income while the property remains offshore. Congress might want to impose an interest charge on the tax liability assessed at the time of the inbound transfer.[79] Congress also may want to adopt a *de minimis* rule allowing U.S. transferees to receive gifts of assets, which, when aggregated, have a relatively low value, without prompting the income-inclusion rule.

[79] The law currently applies an interest cost to foreign trusts. IRC § 668.

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.

Current Law. The rules regarding the basis of property acquired from a decedent change upon repeal of the estate tax in 2010. Before and after the one-year repeal, IRC § 1014 generally applies to allow a recipient of property acquired from a decedent to take a basis in the property equal to its fair market value at the decedent's death. During the one-year repeal, the EGTRRA replaces IRC § 1014 with IRC § 1022's modified carryover basis rule.

1. IRC §§ 1014 and 1015. Before and after the repeal of the estate and GST taxes in 2010, IRC § 1014 determines the basis of property that a taxpayer acquires from a decedent. The carryover basis rule applicable to gifts, IRC § 1015, continues to determine a donee's basis in property acquired by gift even when the estate tax is repealed. IRC § 1016 requires subsequent adjustments to basis for certain items, including an increase to basis for the cost of additional capital improvements and a decrease for depreciation and other cost recovery type allowances taxpayers may take with respect to an asset.

Under IRC § 1015, property that a donee receives from a donor takes a basis equal to the donor's basis (a "carryover basis") plus the amount of gift tax paid on any unrealized appreciation.[80] For purposes of computing loss, however, a donee's basis generally cannot

[80] IRC §1015(a), (d)(1), (6). IRC § 2654(a)(1) authorizes an increase in the basis of property (but not in excess of its fair market value) by the portion of the GST tax attributable to the appreciation in the property immediately prior to the taxable transfer. Any basis adjustment under IRC § 1015 for gift tax paid takes precedence over the IRC § 2654(a)(1) adjustment. The combined adjustments cannot exceed the property's fair market value. IRC § 2654(a)(1) incorporates IRC § 1015 principles for taxable events not having to do with death. IRC § 2654(a)(2) adopts a parallel approach for taxable terminations occurring as a result of a death. It incorporates IRC § 1014's "step-up in basis" rule.

A transfer may be complete for gift tax purposes under Treas. Reg. § 25.2511-2, but not complete for income tax purposes, such as when the transfer is to certain types of so-called grantor trusts. It appears, although it is not certain, that the donor's basis is determined by IRC § 1015 and that, after the transfer, IRC § 1015(d)(6) applies to increase the basis of the asset by the amount of gift tax paid on the difference between the asset's fair market value at the time of the transfer and the donor's basis immediately before the transfer. At least one reason the result is uncertain is because the IRS has ruled in Rev. Rul. 85-13, 1985-1 C.B. 184, that it will disregard for income tax purposes a transfer to a grantor trust. Because no transfer has occurred for federal income tax purposes and because IRC § 1015 is an income tax and not a gift tax provision, it is uncertain if that section applies when a gift is made to a grantor trust. This issue does not arise unless the fair market value at the time of the gift is greater than the donor's basis and the donor pays a gift tax. *See* Jonathan Blattmachr, Mitchell Gans & Hugh Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149, 158 (2002).

exceed the property's fair market value on the date of the gift.[81] IRC § 1223(2) permits a donee to tack on the donor's holding period, provided the donee's basis is the same, in whole or in part, as the donor's basis. The "in part" language would allow tacking even when the statute authorizes a basis adjustment for gift tax paid. When IRC § 1015(a) requires a donee to use the lesser of basis or fair market value rule in calculating loss, the law may not permit a tacking on of the donor's holding period.[82]

Under IRC § 1014, the basis of property acquired from a decedent is its fair market value on the date of the decedent's death or on the alternate valuation date, which IRC § 2032 authorizes if the executor elects it.[83] This rule is commonly referred to as the "step-up in basis" provision, because many decedents transfer assets at death that have appreciated in value.[84] IRC § 1014, however, does require a "step-down in basis" when property has depreciated in value over time. IRC § 1223(11) treats estates or successors in interest as having held any asset for more than one year, regardless of the actual length of a decedent's holding period with respect to that asset, if IRC § 1014 applies to determine that asset's basis.[85]

2. IRC § 1022

a. Dual Basis Rule. When the EGTRRA repeals the estate and GST taxes for 2010, it also repeals IRC § 1014 and replaces it with a modified carryover basis rule. Under the general rule of IRC § 1022(a), property acquired from a decedent takes a basis equal to the lesser of the decedent's adjusted basis or the property's fair market value as of the decedent's death.[86]

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[81] IRC § 1015(a).

[82] Although Rev. Rul. 69-43, 1969-1 C.B. 310, declared I.T. 3453, 1941-1 C.B. 254, obsolete, it remains pertinent regarding the appropriate holding period when a donee sells an asset at a loss. Part-sale/part-gift transactions should qualify for tacking. Citizens Nat'l Bank of Waco v. United States, 417 F.2d 675 (5th Cir. 1969); Treas. Reg. § 1.1015-4. *Cf.* Turner v. Commissioner, 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969) (permitting tacking for a net gift transfer), *nonacq*., 1971-2 C.B.1.

[83] There are exceptions to IRC § 1014's general rule that property acquired from a decedent takes a basis equal to the property's fair market value for estate tax purposes. IRC § 1014(c) (income in respect of a decedent), (d) (domestic international sales company, or DISC, stock), (e) (property the decedent acquires by gift within one year of death). The Report will not reference the alternate valuation date again when describing IRC § 1014.

[84] In community property states, the law treats a surviving spouse's one-half share of community property that the decedent and the surviving spouse (under the community property laws of any state, U.S. possession, or foreign country) held generally as having passed from the decedent. Therefore, the surviving spouse's share of community property is eligible for a step-up in basis. This rule applies if the decedent's gross estate includes at least one-half of the whole of the community interest. IRC § 1014(b)(6).

Several exceptions apply with respect to IRC § 1014. For example, it denies a step-up in basis for stock of a foreign personal holding company. IRC § 1014(b)(5). A partial basis reduction applies to stock in a DISC as well as to stock in a foreign investment company. IRC §§ 1014(d), 1246(e)(1).

[85] *See also* IRC § 1223(12) (providing a tacking rule for special use valuation under IRC § 2032A).

[86] IRC § 1022(a)(2). In addition to preserving the long-standing norm that death does not constitute a realization event for federal income tax purposes, the legislative history of the EGTRRA notes that it "clarifies" a rule by statutory provision that the nonrecognition rule extends to the situation when liabilities exceed basis in an asset at the time of decedent's death. H.R. CONF. REP. NO. 107-84, at 187 (2001). The Senate Report to the EGTRRA provides that the characterization of property acquired from a decedent under IRC § 1022 is determined as if the recipient had received the property by gift. The effect of this rule is that the character of gain on the sale of real property received from a decedent's estate as a result of depreciation recapture rules is transferred to the recipient. *Id*. at 39.

Transfers of property falling within the scope of IRC § 1022 must satisfy two tests. First, the decedent must have owned the property. Second, the recipient of the property must have acquired it from the decedent. The statute prescribes the manner by which a decedent qualifies as having owned the property and by which a recipient qualifies as having acquired it from the decedent.[87]

IRC § 1022(d)(1)(A) establishes rules for making the determination about the decedent's ownership. Assets held by decedents in their names obviously meet the ownership test. The statute applies special rules for more complex forms of ownership, as well as for certain lifetime transfers made in trust or transfers made within three years of death. For example, for joint tenancies with a right of survivorship held by the decedent and the decedent's surviving spouse or tenancies by the entirety, IRC § 1022(d)(1)(B)(i)(I) treats the decedent as having owned one-half of the property. As for other types of joint tenancies, IRC § 1022(d)(1)(B)(i)(II) treats the decedent as having owned the portion of the property attributable to the decedent's contribution.[88] Another example has to do with trusts. IRC § 1022(d)(1)(B)(ii) treats the decedent as the owner of property that the decedent had transferred during life to a trust over which the decedent had retained the right to receive all of its income or to beneficial control.[89] Yet, another statutory rule, IRC § 1022(d)(1)(B)(iii), does not treat the decedent as owner of any property solely because the decedent had held a power of appointment over that property.

As to the second requirement, IRC § 1022(e)(1) treats a person as having acquired property from a decedent, if that person acquired it by gift, devise, or inheritance or if the decedent's estate acquired it from the decedent. In addition, IRC § 1022(e)(2) treats a person as having acquired property from a decedent, if the decedent had transferred it during life to a qualified revocable trust, as IRC § 645(b)(1) defines that term, or to any other trust over which the decedent retained the right to affect beneficial enjoyment, including the right to either amend or revoke the trust. Finally, IRC § 1022(e)(3) treats a person as having acquired property from a

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Before and after 2010, IRC § 684 makes an exception to the rule that death is not a realization event. It requires gain recognition for both lifetime and deathtime transfers of property by a U.S. person to a foreign estate or trust, except a grantor trust as defined under IRC § 671. The EGTRRA extends that rule to include deathtime transfers to a nonresident who is not a U.S. citizen. The gain on the transfer is equal to the difference between the property's fair market value and its adjusted basis in the hands of the transferor. For further discussion of this provision, see *supra* text accompanying note 78. Treas. Reg. § 1.684-3(c) requires recognition of the gain, unless IRC § 1014 applies to determine basis in the transferor's property. Some may question the validity of this regulation. *See*, *e.g*., Blattmachr, Gans & Jacobson, *supra* note 80, at 152. The types of transfers that would qualify under this exception would include a deathtime transfer to a foreign trust and a lifetime transfer made to a foreign grantor trust, which at the transferor's death no longer qualifies as a grantor trust. This regulatory exception for gain recognition under IRC § 684 disappears in 2010, when IRC § 1022 applies to determine basis.

[87] Stock in certain entities does not qualify for an increase to basis. This includes stock or securities in a foreign personal holding company, stock of a DISC or former DISC, stock of a foreign investment company, or stock of a passive foreign investment company (PFIC), unless such a company as to the decedent was a qualified electing fund according to IRC § 1295. IRC § 1022(d)(1)(D). Congress considered these exceptions as necessary in order to preserve the ordinary income character of gains from the sale or other disposition of these types of interests. For further discussion of characterization issues, see Blattmachr, Gans & Jacobson *supra* note 80, at 151–52.

[88] IRC § 1022(d)(1)(B)(i)(III) has to do with jointly owned property that the decedent acquired by gift, devise, or inheritance. Special rules also apply to community property. IRC § 1022(d)(1)(B)(iv).

[89] IRC § 1022(d)(1)(B)(ii) incorporates the definition of a "qualified revocable trust" found in IRC § 645(b)(1).

decedent to the extent that person had acquired it without adequate consideration by reason of the decedent's death.[90]

The EGTRRA ameliorates the tax consequences of a carryover basis rule in a number of ways. As of 2010, it revises IRC § 1040, which has to do with the funding of pecuniary bequests. Revised IRC § 1040 requires recognition of gain upon the executor's transfer of property in satisfaction of a pecuniary bequest only to the extent that the fair market value at the time of the transfer exceeds the fair market value of the property at the decedent's death. By not using the property's carryover basis to compute the gain and by having the pecuniary legatee take the carryover basis increased by the amount of the gain that the estate recognized when it funded the pecuniary bequest, IRC § 1040 defers recognition of the unrealized appreciation that occurred during the decedent's lifetime until the legatee transfers the property in a taxable disposition.[91] IRC § 1040(b) authorizes Treasury to provide similar treatment through regulations for the funding of a right to receive a specific dollar amount from a trust.

The EGTRRA also addresses the problem of property subject to a liability in excess of decedent's basis at the time of decedent's death. IRC § 1022(g)(1) provides that a decedent does not recognize gain at death when the estate or a beneficiary acquires property subject to a liability that is greater than the decedent's basis in the property. Likewise, an estate does not recognize gain on the distribution of property subject to a liability in excess of basis by reason of the liability. The nonrecognition rule of IRC § 1022(g)(1) does not apply if the transfer is from the decedent or the decedent's estate to a tax-exempt beneficiary, which includes: (i) "the United States, any State or political subdivision thereof, any possession of the United States, any Indian tribal government (within the meaning of section 7871), or any agency or instrumentality of any of the foregoing;" (ii) an organization exempt from tax (other than a farmers' cooperative, described in IRC § 521); (iii) any foreign person or entity; or (iv) "to the extent provided in regulations, any person to whom property is transferred for the principal purpose of tax avoidance."[92]

b. <u>Conforming Amendment to IRC § 121</u>. The EGTRRA addresses gain on the sale of a decedent's personal residence. Under IRC § 121, the Act extends the income tax exclusion of up to $250,000 of gain on the sale of a principal residence to a decedent's estate and to any person who acquires the residence from the decedent.[93] If the decedent had used the property as a principal residence for two or more years during the five-year period prior to the sale and if the decedent's estate or a recipient of the residence sells it, IRC § 121 excludes $250,000 of gain on its sale. In addition, if a recipient of the decedent's personal residence occupies it as a principal residence, IRC § 121(d)(9) adds the decedent's period of ownership and occupancy of the property as a principal residence to the recipient's subsequent ownership and occupancy in determining whether the recipient meets the two-year personal residency rule.

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[90] Presumably, Congress intended the reference to a "consideration" requirement under this provision to incorporate, by regulations, the "money or money's worth" standard and the applicable rules contained in IRC § 2043.
[91] IRC § 1040(c).
[92] IRC § 1022(g)(2).
[93] IRC § 121(d)(9) (effective Jan. 1, 2010).

c. Modifications to Carryover Basis. IRC § 1022(b)(2)(B) permits an increase in the basis in assets that the decedent owned and recipients acquired at the decedent's death by up to a total of $1.3 million plus an inflation adjustment factor.[94] IRC § 1022(b)(2)(C) further increases the $1.3 million basis adjustment by the amount of unused capital losses, net operating losses, and certain "built-in" losses of the decedent.[95] The purpose of these modifications to basis is to preserve tax attributes of a decedent beyond death. In addition, IRC § 1022(c) increases the basis of property transferred to a surviving spouse, provided such property meets the definition of qualified spousal property, by up to an additional $3 million adjusted for inflation.[96] Qualified spousal property consists of property that the decedent transfers outright to the spouse and qualified terminable interest property.[97] Therefore, in addition to adjustments for loss carryovers and built-in losses, a surviving spouse can enjoy increases to basis of up to $4.3 million.

The aggregate basis increase of $1.3 million and the aggregate spousal property basis increase of $3 million presumably serve two purposes. First, incident to repeal of the estate and GST taxes, Congress did not want to increase income taxes for those who previously had not been subject to estate taxes but nevertheless enjoyed a step-up in basis. The $1.3 million and $3 million allowances can be expected to achieve this goal, except in those situations in which surviving spouses receive assets that have appreciated more than $4.3 million during the time the decedent was holding the assets.

The basis increases serve a second purpose of making tax administration and compliance simpler for many estates in which the records regarding a decedent's basis are inadequate. Although the law requires all taxpayers to keep adequate records as necessary for the determination of their tax liabilities, many taxpayers have not maintained adequate records to meet the requirements of a carryover basis rule at death.[98] The long-standing rule of IRC § 1014 generally had promised a new basis at death.[99] This rule, had it endured, would have made record

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[94] IRC § 1022(d)(4)(A) provides for the inflation adjustment. For ease of exposition, the Report generally will not refer further to the fact that the statute provides for indexing the $1.3 million amount.

As to nonresidents who are not U.S. citizens, the aggregate basis exemption is limited to up to $60,000 (plus inflation adjustment). IRC § 1022(b)(3).

[95] For further discussion of loss carryovers and built-in losses, see *infra* § 10.

[96] Again, for ease of exposition, the Report generally will not refer further to the fact that the statute provides for indexing of the $3 million adjustment that IRC § 1022(d)(4)(A) authorizes.

[97] IRC § 1022(c)(3)-(5).

[98] IRC § 6001.

[99] The practice of marking the basis of assets transmitted at death to market began at the inception of the modern income tax. Committee on Appeals & Review Mem. 30-19-637, 1 C.B. 38 (1919). The rule that later became IRC § 1014 had applied since 1913, although Treasury did not announce it until 1919. The Revenue Act of 1921 first codified the rule in § 202(a)(2) of that Act. ch. 136, § 202(a)(2), 42 Stat. 227, 229.

Property transmitted at death was not the only property marked to market under the early income tax. Property acquired by gift on or before December 31, 1920, was also "the fair market price or value of such property at the time of such acquisition." *Id*. The practice of providing a basis equal to the fair market value for gifts, bequests, devises, and inheritances was conceptually consistent with the Revenue Act of 1913's exemption of gifts and bequests from income tax. The exclusion of property received through lifetime or deathtime donative transfers reflects an early concern that the Sixteenth Amendment, in authorizing the taxation of "income," did not authorize the taxation of "principal." 50 CONG. REC. 3842-44 (1913). Taft v. Bowers, 278 U.S. 470 (1929), unanimously upheld the carryover basis rule for gifts, with Chief Justice Taft, who as President of the United States had signed the Revenue Act of 1913 into law, not participating.

keeping of the costs and adjustments to costs unnecessary for assets that decedents had intended to hold until death.[100] Consequently, many taxpayers simply have not maintained records for assets they planned to hold until death. This has been particularly true for personal use assets, typically, tangible assets not held for investment and not used in the conduct of a trade or business. Although the two allowances of basis increases simplify tax administration and tax compliance, they can favor larger estates and estates that contain greater amounts of unrealized appreciation.

IRC § 1022(b) and (c) reflect the only adjustments to basis as a result of acquiring property from a decedent. IRC § 1022 omits any consideration of an adjustment for estate administration expenses. Under IRC § 642(g), the executor of an estate can elect to deduct estate administration expenses on either the decedent's estate tax return (Form 706) or the fiduciary income tax return (Form 1041). An executor typically compares the respective marginal income and estate tax rates of the estate and deducts the expenses on whichever return will generate the most tax savings. After the repeal of the estate tax, an executor will be able to deduct these estate administration expenses only on the fiduciary income tax return. If the estate has little or no income, the deductions for estate administration expenses may not lead to a reduction of income taxes for the estate.[101]

The modifications to carryover basis have important limitations. The first is that the modified basis for any asset may not exceed its fair market value determined at the date of the decedent's death.[102] The second is that certain types of property are not eligible for either the aggregate basis or aggregate spousal property basis increase. The list of ineligible property includes: (i) property the decedent acquired by gift, other than from the decedent's spouse, during the three-year period ending on the date of the decedent's death;[103] (ii) property that constitutes a right to receive income in respect of a decedent;[104] (iii) stock or securities of a foreign personal holding company; (iv) stock of a domestic international sales corporation, or former domestic international sales corporation; (v) stock of a foreign investment company; and (vi) stock of a passive foreign investment company, except for which a decedent shareholder had made a qualified electing fund election.[105]

IRC § 1022(d)(3)(A) requires the executor of an estate to allocate the basis modifications among the estate's assets and to file a return regarding that allocation. IRC § 1022(d)(3)(B) provides that an executor can change an allocation only in a manner provided by Treasury.[106] IRC § 6018, as amended and effective for 2010, sets forth the reporting requirements for an executor. It applies to transfers at death of noncash assets in excess of $1.3 million and generally for appreciated property that the decedent had acquired within three years of death for which the

[100] Arguably, given the temporary repeal of the estate and GST taxes and the temporary replacement of IRC § 1014 with IRC § 1022, taxpayers may continue to believe that record keeping to establish the basis of property acquired from a decedent is unnecessary.
[101] *See* IRC §§ 55, 67, 68, 212.
[102] IRC § 1022(d)(2). For further discussion of the fair market value limitation, see *supra* § 7.2.
[103] IRC § 1022(d)(1)(C)(i).
[104] IRC § 1022(f). For the definition of income in respect of a decedent, see IRC § 691(a); Treas. Reg. § 1.691(a)-1(a).
[105] IRC § 1022(d)(1)(D).
[106] For further discussion of the allocation rules, see *infra* § 12.

law required the donor to file a gift tax return. If IRC § 6018 applies, the executor of the estate (or the trustee of a revocable trust) must report to the IRS information concerning the recipient of the property, an accurate description of the property, the decedent's adjusted basis in and holding period of the property, and the property's fair market value at the decedent's death. In addition, the executor must report information relating to whether any gain on the sale of the property would be treated as ordinary income, the amount of basis increase the executor allocated to the property, and any other information as regulations may require.[107] The statute also requires the executor to furnish the same information to the recipients of the decedent's property.[108] For executors of nonresident aliens' estates, IRC § 6018 requires reporting only if the aggregate value of tangibles situated in the United States and other property acquired from the decedent by a U.S. person exceed $60,000.[109] Penalties are imposed for failure to file the required information subject to a reasonable cause defense.[110]

Treasury regulations ultimately issued for IRC § 1022 are likely to have a significant effect on its operation. IRC § 1022(h) directs the Secretary of the Treasury to issue regulations to carry out the purposes of IRC § 1022, including the applicable rules pertaining to the allocation of the aggregate basis and aggregate spousal property basis exemptions.[111] The discussion that follows includes consideration of issues that those regulations might address.[112]

IRC § 1022(b) and (c) benefit larger estates relative to smaller ones. Further, they benefit estates containing assets with unrealized appreciation more than estates containing assets with relatively less unrealized appreciation. Example 1 compares the treatment of estates of unequal value under IRC § 1022(b) and (c).

> *Example 1: Two estates of unequal value at the time of the death of the decedents. G-1* dies owning assets, each with a zero basis and, in the aggregate, a fair market value of $4.3 million. She leaves a will that bequeaths the entire estate outright to her husband, *H*. The aggregate basis of the assets in *H*'s hands, after the basis increases provided in IRC § 1022(b)(2)(B) and (c), is $4.3 million. The basis modifications permanently exclude the $4.3 million of gain from income tax. In contrast, *G-2* dies owning assets, each with a zero basis and, in the aggregate, a fair market value of $2 million. He also leaves a will that bequeaths the entire estate to his surviving spouse, *W*. The basis increases prevent *W* from incurring any income tax on gain upon subsequent disposition of the assets up to the assets' $2 million value. If the assets of the second estate

[107] IRC § 6018(c).
[108] IRC § 6018(e).
[109] IRC § 6018(b)(3).
[110] *See* IRC § 6716.
[111] For an example of similar legislation, see IRC § 2663 (authorizing Treasury to issue legislative regulations pertaining to three different areas of transfer tax law). The congressional grant of authority will make the regulations that Treasury issues under IRC § 1022 legislative in nature. *See* Rowan Companies, Inc. v. United States, 452 U.S. 247, 253 (1981) (establishing a standard of review for challenging legislative regulations). For other cases addressing legislative regulations, see Allstate Ins. Co. v. United States, 329 F.2d 346, 349 (7th Cir. 1964) (holding that legislative regulations have the "force and effect of law, so long as they were reasonably adapted . . . to the administration and enforcement of the act and did not contravene some statutory provision"); Woods Inv. Co. v. Commissioner, 85 T.C. 274, 279, 282 (1985), *acq*., 1986-2 C.B.1 (holding that a taxpayer is entitled to apply the investment basis rule contained in the consolidated return regulations, which are legislative in character and enforceable unless clearly contrary to the will of Congress, even if those regulations result in a double deduction to the taxpayer).
[112] For regulatory provisions that Treasury may consider, see *infra* §§ 10 and 12.A.

appreciate by another $2.3 million before *W* sells them, that $2.3 million of the gain would be taxed. The law benefits the larger estate by providing it $2.3 million more in basis increases than it provides the smaller estate. At the time both surviving spouses sell the assets, which they acquired from their respective spouses, the assets had the same fair market value. Nevertheless, *W* has to pay taxes on a $2.3 million gain, which at the highest capital gain rate scheduled to apply in 2010, would result in a tax liability of $460,000.[113] *H*, on the other hand, has no gain and, therefore, no tax liability.

As example 2 illustrates, if the two decedents have estates with the same fair market value of $4.3 million, the fair market value limitation of IRC § 1022(d)(2) benefits that estate that contains assets with relatively lower bases.

Example 2: Two estates of equal value at the time of the death of the decedents. G-1 dies owning one asset. It has a basis of zero. She leaves her estate outright to *H*. *G-2* also dies owning one asset. It has a basis of $4.3 million. He leaves his estate outright to *W*. *H* enjoys a basis increase of $4.3 million, but *W* receives no basis increase at all. The law effectively favors surviving spouses of decedents with unrealized appreciation over those of decedents who died with little or no unrealized appreciation.

The difference in treatment would seem particularly harsh if *G-2* had sold an asset immediately before death with a fair market value of $5,375,000 and a basis of zero and had to pay a tax on the gain of $1,075,000 (20 percent [highest applicable capital gain rate] x $5,375,000 [realized capital gain]) and then reinvested the after-tax proceeds of $4.3 million ($5,375,000 – $1,075,000) in another asset immediately before death.[114] Had *G-2* not sold the asset prior to death and, instead, had died owning the appreciated asset, *W* could have sold it at its fair market value and recognized a gain of only $1,075,000 ($5,375,000 [amount received] – $4,300,000 [modified carryover basis]) and paid a tax of only $215,000 (20 percent [highest applicable capital gain rate] x $1,075,000 [realized capital gain]).

The fair market value limitation of IRC § 1022(d)(2) can also operate harshly with regard to the basis increases for net operating loss carryovers, capital loss carryovers, and built-in losses. The amount of unrealized appreciation in the assets acquired from a decedent will determine whether these basis increases are available. IRC § 1022(d)(2) treats successors to a decedent's property more favorably, if the decedent dies with losses as well as low-basis assets relative to their fair market values than if the decedent dies with losses and high-basis assets relative to their fair market values.

d. <u>A Comparison of the Income Tax Consequences of Lifetime and Deathtime Transfers</u>. The general perception is that the EGTRRA treats lifetime and deathtime transfers similarly for income tax purposes. The discussion that follows indicates those areas in which the income tax law under the EGTRRA treats them differently. Although much of the analysis compares IRC §§ 1015 and 1022, it also considers other income tax provisions that result in disparate income tax treatment of lifetime and deathtime transfers.

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[113] The JGTRRA reduces the highest capital gain tax rate to 15 percent for gains taken into account after May 5, 2003, but that rate will increase again to 20 percent for net capital gains recognized after 2008. For further discussion of the JGTRRA's rate changes, see *supra* note 24. At the 15 percent rate, the surviving spouse of the second decedent would have a tax liability of $345,000 (15 percent x $2.3 million).

[114] The example assumes that the 20 percent capital gain rate applies. For a discussion of the JGTRRA's reduction of tax rates before 2009, see *supra* note 24.

The primary reason for the perception that, under the EGTRRA, the income tax law treats deathtime transfers similarly to lifetime ones is that IRC § 1022 requires property acquired from a decedent to take the decedent's basis in that property. While there is a superficial similarity between the carryover basis rule for transfers by lifetime gift under IRC § 1015 and the carryover basis rule for transfers at death under IRC § 1022, there are significant differences in how each operates. For assets covered by IRC § 1022, the general rule is that basis is the lower of the asset's fair market value at the time of the decedent's death or the decedent's basis immediately prior to death. The basis for property transferred by lifetime gift is the donor's basis. For the purpose of determining the recipient's loss on the disposition of the property, however, the donee's basis is the property's fair market value at the time of the gift, in the event that the fair market value was lower than the donor's adjusted basis at that time.[115] In other words, the basis of an asset transferred by gift is the donor's basis, except that, in computing a loss from the sale or disposition of an asset, the statute requires that the donee use the fair market value of the property at the time of the gift, if that fair market value was less than basis. If the asset is sold or exchanged at a price between the donor's basis and the lower fair market value at the time of the gift, the donee realizes neither gain nor loss.[116]

On account of inflation, reduction in income tax basis for depreciation under IRC § 1016(a)(2), and other factors, transferees generally have preferred to acquire an asset from a decedent and take a basis in the property equal to its fair market value at the date of decedent's death under IRC § 1014, rather than to acquire it by lifetime gift and take a carryover basis under IRC § 1015.[117] Under the modified carryover basis rule that accompanies estate tax repeal in 2010, a different type of disparity arises between assets a transferor transfers at death and those a transferor transfers during life. Property transferred by gift continues to have its basis determined under IRC § 1015, which generally is the donor's basis at the time of the transfer. Property acquired from a decedent, within the meaning of IRC § 1022, has a basis equal to the lesser of the asset's fair market value at the time of the decedent's death or the decedent's basis immediately prior to death (subject to certain adjustments discussed elsewhere).[118] Hence, essentially in a general "reversal of fortunes" during 2010, it may be preferable to receive assets by lifetime, rather than by deathtime, transfer. One justification for the preferential treatment of lifetime transfers in 2010 is that the gift tax continues to operate and impose a gift tax liability. The problem with that explanation for the disparate treatment is that lifetime transfers may escape taxation if the transfers qualify for the annual exclusion, qualify for the gift tax marital deduction, or are within the limits of the transferor's gift tax applicable exclusion amount.

i. Impact of IRC § 1022 Modifications. IRC § 1022 allows three modifications of the decedent's carryover basis: an adjustment of up to $1.3 million, an increase for

[115] IRC § 1015(a).
[116] Treas. Reg. § 1.1015-1(a)(2) (Ex.).
[117] The basis could be the fair market value determined on the alternate valuation date under IRC § 2032. *See* IRC § 1014(a)(2). It could also be less than fair market value if the estate elects to use the special use valuation rules of IRC § 2032A. *See* IRC § 1014(a)(3). As noted, if the property owner's basis is greater than fair market value, it may be preferable for income tax purposes for the transferee to receive the asset by lifetime gift.
[118] For further discussion of the definition of property acquired from the decedent, see *supra* § 7.2.a. For a discussion of modifications to basis under IRC § 1022, see *supra* § 7.2.c. and *infra* §§ 10 and 11.

certain unused losses of the decedent, and an increase for certain qualifying spousal property of up to $3 million.[119] The statute denies modifications that increase basis, however, if they cause the basis of an asset to exceed its fair market value at the decedent's death.[120] In contrast, IRC § 1015 does not allow any of these modifications to the basis of property transferred by gift. Hence, the basis of a given asset may be quite different depending on whether the transferor makes a lifetime or deathtime transfer; the recipient's basis in the property may be higher, lower, or the same if the transferor makes a lifetime, rather than a deathtime, transfer.

ii. <u>Holding Periods</u>. Another distinction between IRC §§ 1015 and 1022 relates to holding periods.[121] The law treats gain or loss on the sale of a capital asset, which IRC § 1221 defines, differently depending on whether the taxpayer has held the asset for more than one year or for one year or less. IRC § 1223(2) generally determines the holding period of an asset in the hands of a donee by reference to the donor's holding period, because it attributes the donor's holding period to the donee whenever IRC § 1015 determines the donee's basis, in whole or in part, by reference to the donor's basis.[122] For the purpose of a loss, the basis of an asset transferred by gift is its fair market value, if the donor's basis is greater than fair market value at the time of the gift.[123] Hence, for the purpose of a loss, the holding period of such an asset in the hands of the donee apparently commences upon the date of the gift.

In instances in which IRC § 1022 determines a recipient's basis by reference to the decedent's basis, then IRC § 1223(2) attributes the decedent's holding period to the recipient. In this regard, the two statutes operate in a similar manner. A decedent's holding period also should be attributable to the recipient's basis in instances in which IRC § 1022(b) or (c) modifies the decedent's basis as determined under IRC § 1022(a)(2)(A). However, in instances in which IRC § 1022(a)(2)(B) results in a recipient taking a basis in an asset equal to its fair market value at the date of the decedent's death, that basis is not determined, in whole or in part, by the decedent's basis.[124] Therefore, the holding period of such an asset in the hands of the recipient does not include the decedent's holding period. Although both IRC §§ 1015 and 1022 can result in a holding period that commences at the time the transferor makes the transfer, this does not mean that they lead to the same results. Regardless of whether a recipient sells an asset for a gain or loss, IRC § 1022 requires the recipient to take a basis in an asset equal to its fair market value at death, if that fair market value is less than the decedent's basis. IRC §

[119] For property acquired from a nonresident alien decedent, the statute does not permit an adjustment for such losses, and the adjustment is $60,000, rather than $1.3 million, with no increase for carryovers. IRC § 1022(b)(3).
[120] IRC § 1022(d)(2).
[121] For a discussion of the differences in the holding periods between IRC §§ 1014 and 1022, see *supra* § 7.1.
[122] Treas. Reg. § 1.1223-1(b).
[123] For a discussion of how IRC § 1015 determines a donee's basis for purposes of a sale or exchange resulting in a loss, see *supra* text accompanying note 115.
[124] A decedent's holding period is attributable to a recipient's basis in those instances in which that basis is determined by reference to the decedent's basis under IRC § 1022(a)(2)(A), even though the recipient's basis may be subject to the fair market value limitation of IRC § 1022(d)(2).

1015, on the other hand, requires the donee to use a basis determined exclusively by reference to the asset's fair market value at the time of the transfer only if the donee sells that asset for less than its fair market value at the time of the transfer.

iii. Availability of Exclusion of Gain Under IRC § 121. Yet another distinction between lifetime and deathtime transfers relates to a transferor's principal residence. Under IRC § 121(d)(9), a recipient of the decedent's principal residence generally may use the decedent's $250,000 exclusion. In addition, if the recipient occupies the property as a principal residence, IRC § 121(d)(9) attributes the decedent's period of ownership and occupancy of the property as a principal residence to the recipient to determine the recipient's qualification for the exclusion. If transferors make lifetime gifts of their personal residences, their donees will not receive similar favorable tax treatment under IRC § 121.

iv. Transfers of Property to Non-U.S. Transferees. IRC § 684(a) requires recognition of gain on transfers of appreciated property by U.S. transferors to foreign estates or trusts. The EGTRRA, as of 2010, extends recognition treatment to a deathtime transfer made to a nonresident who is not a U.S. citizen.[125] IRC § 684(b)(2) expressly makes an exception from recognition treatment for a lifetime transfer to a nonresident who is not a U.S. citizen and, therefore, establishes yet another distinction between lifetime and deathtime transfers under the income tax.[126]

v. Transfers of Property with Liabilities in Excess of Basis. Another distinction between lifetime and deathtime transfers relates to an asset that is subject to liabilities in excess of its basis. Under Treas. Reg. § 1.1001-2(c) (Ex. 5), a taxpayer must recognize gain upon a lifetime transfer of an asset to the extent that asset is subject to liabilities in excess of its basis.[127] Under IRC § 1022(g), gain is not recognized, even if liabilities are in excess of basis, by reason of a transfer by a decedent or by the decedent's estate, unless the transfer is to a tax-exempt entity, to a foreign person or entity, or, to the extent provided in regulations, to any other person for the principal purpose of tax avoidance.[128]

vi. Charitable Remainder Trusts. A charitable remainder trust, described in IRC § 664, provides certain tax benefits for the grantor and trust beneficiaries. As a general rule,

[125] IRC § 684(a), (b)(1).

[126] For further discussion of IRC § 684 and a discussion of a proposal to eliminate the exception under IRC § 684 for lifetime gifts to a "nonresident alien," see *supra* § 6.

[127] *See* Crane v. Commissioner, 331 U.S.1 (1947); *cf.* Diedrich v. Commissioner, 457 U.S. 191 (1982) (holding that the excess of gift tax paid by the donee over the donor's basis in property was taxable income to the donor).

[128] The relief provided by IRC § 1022(g) is not unique under the income tax law. IRC § 1041 provides similar relief for interspousal transfers and transfers incident to divorce of property having liabilities in excess of the transferor's adjusted basis. This exception is not available, however, for interspousal transfers made in trust to the extent described under IRC § 1041(e). *See also* Treas. Reg. § 1.1502-19 (providing for recapture of the excess loss account on disposition or deemed disposition of subsidiary stock).

It seems generally accepted that, under current law, no gain is recognized upon the death of a decedent, even with respect to an asset whose liabilities are in excess of the basis, as determined under IRC § 1014. *See* Blattmachr, Gans & Jacobson, *supra* note 80, at 152 n.22.

the trust is exempt from income tax, and its grantor is entitled to an income and gift tax deduction for a lifetime transfer to such a trust. Before and after 2010, an estate is entitled to an estate tax deduction for a deathtime transfer to such a trust. However, a charitable remainder trust is defined as one for which IRC §§ 170, 2055, 2106, or 2522 allows an income, estate, or gift tax deduction.[129] Upon repeal of the estate tax, obviously, there is no estate tax deduction for a testamentary transfer to a charitable remainder trust. Because the decedent will not have made the transfer during life, IRC § 170 will not allow an income tax deduction, and IRC § 2522 will not allow a gift tax deduction. IRC § 642(c) does not appear to permit an income tax deduction to the estate or trust that funds a testamentary charitable remainder trust.[130]

vii. <u>State Death Taxes</u>. Under IRC § 1015(d)(6), a donee's basis in property received by gift is the donor's basis in that property increased—but not above the fair market value of the property—by the amount of federal gift taxes paid on the difference between the asset's fair market value at the time of the transfer and the donor's basis immediately before the transfer. IRC § 1015 does not, however, provide for an adjustment to an asset's basis for any state gift taxes paid. IRC § 1022 also does not permit an adjustment to basis for state death taxes. Similarly, under IRC § 691(c), a deduction is available for federal, but not for state, estate taxes paid on income in respect of a decedent.[131] Accordingly, there currently is no precedent for permitting an adjustment for state transfer taxes under the income tax.

e. <u>Closely Held Businesses</u>. The repeal of the estate and GST taxes and the introduction of the modified carryover basis rule under IRC § 1022 may significantly change the estate planning issues that owners of interests in closely held businesses face.

i. <u>Liquidity Requirements</u>. Although many estates need to sell assets to satisfy estate obligations—including debts, administrative costs, and tax liabilities—liquidity problems generally are more acute for estates that contain a high proportion of valuable interests in closely held businesses. When there is no ready market, the decedent's estate must have sufficient other assets or sources of funds from which to pay the estate tax attributable to the closely held business interests.

When the owners of a closely held business enter into an agreement to purchase the interest of a deceased owner, the agreed purchase price may not be determinative of the interest's estate tax value. Frequently, there is a stark difference between what the

[129] Treas. Reg. § 1.664-1(a)(iii)(a).

[130] IRC § 642(c) allows an income tax charitable deduction to an estate only for contributions of "gross income." For this purpose, gross income includes amounts received by the estate as income in respect of a decedent. Treas. Reg. § 1.642(c)-3(a). *See* Estate of Bluestein v. Commissioner, 15 T.C. 770 (1950); Estate of Lowenstein v. Commissioner, 12 T.C. 694 (1949), *aff'd sub nom.* First Nat'l Bank of Mobile v. Commissioner, 183 F.2d 172 (5th Cir. 1950); *see also* F.S.A. 200140080 (Sept. 4, 2001) (permitting a trust a deduction under IRC § 642(c) for a share of the partnership charitable contribution, even though the trust instrument did not permit contributions to charity).

[131] The subsequently repealed carryover basis rules included in the 1976 Tax Reform Act would have permitted a deduction under IRC § 691(c), having to do with income in respect of a decedent, for state death taxes. Pub. L. No. 94-455, § 2005, 90 Stat. 1520, 1872 (repealed 1980).

remaining owners would consider an affordable and fair purchase price and what the regulations under IRC § 2031 require in determining fair market value under the hypothetical willing buyer-willing seller standard.[132] If a majority of the owners is related, IRC § 2703 provides that the purchase price set out in the agreement is not binding for estate tax purposes, unless certain requirements are met. Before an agreement controls the estate tax value, the owners may have to use a formula pricing mechanism consistent with agreements that unrelated parties negotiate at arm's length and with commercially acceptable standards.

If the business interest is significant in relation to the overall size of the decedent's gross estate and meets certain additional qualifications, such as being an active trade or business, IRC § 6166 permits the estate taxes allocable to that interest to be paid over a period of up to fifteen years.[133] Even when an executor elects to pay estate taxes over the fifteen-year deferral period, maintaining eligibility under IRC § 6166 can be complicated, and IRC § 6166(g) provides that the failure to continue to qualify results in the acceleration of the estate tax liability.

With the repeal of the estate and GST taxes, the liquidity needs for estates holding substantial interests in closely held businesses diminish. Although it is difficult to predict the changes in estate planning strategies that owners of interests in closely held businesses may adopt upon repeal of the estate and GST taxes, it is easy to anticipate that, so long as repeal of the estate and GST taxes remains temporary, the owners are going to be reluctant to make changes in their estate plans in reliance on repeal.[134]

ii. Lifetime Gifts. A permanent repeal of the estate tax reduces the tax incentives to make gifts, including gifts of interests in closely held businesses. Yet, owners may have other reasons, including seeking income tax savings, to make gifts. The EGTRRA's retention of the gift tax means that owners of interests in closely held businesses are going to rely on the panoply of valuation strategies available to reduce the value of their gifts, including valuation discounts for lack of marketability or control.[135] Owners may continue to enter into intrafamily sales to shift ownership to the next generation of managers at a reduced gift tax cost. They may incur a gift tax if they enter into various types of entity-level events, such as the formation of a corporation or partnership, capital contributions, and recapitalization exchanges, depending on how they structure them.[136] In sum, estate tax repeal, accompanied by the continuation of the gift tax, is likely to make owners of interests in closely held businesses reluctant to make lifetime gifts of

[132] For further discussion of valuation issues in general and purchase agreements in particular, see *infra* § 18.
[133] For further discussion of IRC § 6166, see *infra* § 25.
[134] For further discussion of the complications of temporary repeal and the long-term phaseout period on owners of closely held businesses, see *supra* §§ 2, 4.
[135] *See*, *e.g.*, Walton v. Commissioner, 115 T.C. 589 (2000). For further discussion of valuation issues under the gift tax law, see *infra* § 18.
[136] *See* Estate of Trenchard, T.C. Memo. 1995-121, 69 T.C.M. (CCH) 2164; IRC § 2701(e)(5); Treas. Reg. § 25.2701-1(b)(2)(i)(B).

them, notwithstanding planning strategies that can significantly reduce, and even eliminate, gift tax liability.[137]

iii. Income Tax Planning of Sales of Interests in Closely Held Businesses. Under the estate tax/step-up in basis rules, the tax law treats a sale of an interest in a closely held business after its owner's death more favorably than it does its sale during the owner's life. The more favorable tax treatment is attributable to IRC § 1014's step-up in basis rule, whereby the estate's basis for federal income tax purposes in the business interest generally is its fair market value at the date of death.[138] Accordingly, in many instances, a sale by an estate of an interest in a closely held business does not result in any significant realized gain or income tax liability.

IRC § 318's attribution of ownership rules may prevent long-term capital gain treatment upon the redemption of closely held stock.[139] When the redemption does not meet the statutory requirements for a sale or exchange under IRC § 302(b), dividend income results to the extent of the corporation's earnings and profits. The potential for dividend income treatment also arises for nonsale or exchange redemptions of stock interests in certain S corporations.[140]

The repeal of the estate tax and IRC § 1014 in 2010 significantly reduces the income tax benefits of postmortem sales of interests in closely held businesses. Under IRC § 1022, the successor's basis in a decedent's interest in a closely held business is the decedent's adjusted basis increased by the basis increases provided for under IRC § 1022(b) and (c). Redemptions of appreciated closely held business interests at death may, notwithstanding the repeal of IRC § 1014, result in little or no income tax liability, if the modified carryover basis in the closely held business interest is sufficient to absorb the entire amount realized. For redemptions of stock from corporations having earnings and profits, the potential still exists for dividend income treatment, if the redemption is not a sale or exchange as defined under IRC § 302(b).[141] A redemption under IRC § 303 for the payment of death taxes has far less significance after the repeal of the federal estate tax.[142] Under IRC § 1022, a redemption qualifying under IRC § 303 may still produce a

[137] For further discussion of the gift tax and closely held businesses, see *supra* §§ 2 and 5. For a discussion of valuation issues, see *infra* § 18.

[138] No step-up in basis is available for items of income in respect of a decedent. IRC §§ 691, 1014(c). For appreciated interests in entities that are partnerships for tax purposes, a partnership may elect under IRC § 754 to have the basis of partnership property adjusted for the estate's share of the partnership's assets. The adjustment is to the estate tax value of the estate's partnership interest. The adjustment may give rise to additional cost recovery allowances to the estate or the purchaser of the decedent's interest. IRC §§ 168, 167, 197.

[139] The attribution rules of IRC § 318 are subject to the exceptions provided for under IRC § 302(c)(2)(A), relating to family attribution rules, and (C), relating to entity attribution rules.

[140] *See* IRC § 1368(c)(2).

[141] The potential for dividend treatment means that attribution and waiver rules remain pertinent. Cross-purchases of stock among shareholders will avoid the dividend issues that arise under IRC §§ 302 and 303. Moreover, a cross-purchase will not result in an adjustment to earnings and profits or, with respect to an S corporation, an accumulated adjustment account. *See* IRC §§ 312(n)(7), 1368(e)(1)(B).

[142] IRC § 303(a)(1) and (2) apply to redemptions for the payment of state death taxes and funeral and administrative expenses and not just federal estate taxes. For further discussion of state death taxes, see *supra* §§ 3, 7.2.d.

capital gain, if the modified carryover basis in the closely held stock is insufficient to absorb the amount realized.

For interests in entities that are treated as partnerships for federal income tax purposes, the EGTRRA's repeal of the estate tax and IRC § 1014 and enactment of IRC § 1022 mean that tax outcomes and planning strategies are the same for lifetime and deathtime redemptions. IRC § 736(b) treats most redemptions as sales or exchanges, if capital is a material, income-producing factor for the partnership. When there is a gain, the tax law frequently bifurcates the character of that gain between ordinary income and long-term capital gain components under IRC § 707(a)(2)(B), 731(c), 737, or 751(b). If partners enter into a cross-purchase agreement, IRC § 751(b) controls the characterization of the gain. IRC § 754 permits a partnership to elect to have the basis of partnership assets adjusted with respect to the purchaser's interest.[143] Treasury presumably will make conforming amendments to regulations under IRC §§ 743(b) and 754 to take into account IRC § 1022's basis increases that an executor allocates to partnership or limited liability company interests acquired from a decedent.

iv. <u>Summary of Planning for Closely Held Businesses</u>. Estate tax repeal does not generate new and different issues concerning the choice of entity for owning and operating a closely held business. Additionally, the replacement of the step-up in basis rule of IRC § 1014 with the modified carryover basis rule of IRC § 1022 does not change an owner's incentive to postpone the sale or exchange of an appreciated interest in a closely held business until death. Both statutes allow for an increase in basis and, therefore, a reduction in the amount, if any, of a realized gain upon the sale or exchange of an interest in a closely held business after the owner's death.

Alternatives

1. <u>Treat Unrecognized Losses Consistently</u>. 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.[144] 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. 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 transfer.

[143] *See* IRC § 743(b).
[144] For further discussion of the strict carryover basis rule, see *infra* §§ 13.

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. Congress's commitment to limit the tax consequences of carryover basis to larger estates with substantial unrealized appreciation is its impetus for the two basis increase allowances of $1.3 million and $3 million. This alternative is based on the assumption that Congress intends to provide some type of income tax exclusion provision, such as a basis increase.[145]

Like IRC § 1022(b) and (c), an IRC § 1014-type allowance favors taxpayers with appreciated, as opposed to unappreciated, property. This alternative is inconsistent with the central purpose of a carryover basis rule, i.e., to preserve the taxability of unrealized gains in the hands of a successor owner of a decedent's assets. Its advantage, however, is that it would eliminate the necessity of knowing or finding the historic cost or adjusted basis of a decedent's property, which basis increases under IRC § 1022(b) and (c) require.[146] The problem of determining basis is likely to be greatest for tangible personal property not held for investment or used in a trade or business. Therefore, Congress could limit the IRC § 1014-type allowance to these assets.[147] 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.[148]

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.[149] As

[145] For a discussion of an alternative to a strict carryover basis rule without modifications, see *infra* § 15.

[146] The rule would only further administrative simplicity if the IRC § 1014-type allowance applies to a class of property that is mutually exclusive from the class of property that would be subject to basis increases under IRC § 1022(b) and (c). To the extent the law provides options or elections, fiduciaries and decedents are likely to spend time and effort to determine which type of allowance will minimize tax consequences. The result would be to introduce complexity, rather than simplicity, and the whole purpose of an IRC § 1014-type allowance would be lost.

[147] The Tax Reform Act of 1976 enacted a carryover basis rule that was to be effective for decedents dying after December 31, 1976, but was subsequently repealed. Pub. L. No. 94-455, § 2005, 90 Stat. 1520, 1872 (repealed 1980). It included a conceptually similar $10,000 allowance, which pertained to "personal and household effects." *See* H.R. REP. NO. 94-1380, at 38 (1976).

[148] Presumably, the amount of the IRC § 1014-type allowance would be greater than the reduction in the IRC § 1022(b) basis increase amount, because the former is an allocation based on an asset's fair market value and not just the difference between its fair market value and the adjusted basis of the decedent.

[149] Unlike the state death tax credit, which the EGTRRA phases out in 2005, the foreign death tax credit provided under IRC § 2014 remains in place until 2010, when the EGTRRA repeals the estate tax. *See also* IRC § 2053(d) (permitting estates to elect to deduct foreign death taxes in lieu of claiming the credit under IRC § 2014). Since,

previously discussed, until 2005, IRC § 2011 permits an estate a credit against the federal estate tax for a portion of the state death taxes paid. Thereafter, in calculating the federal taxable estate, a deduction is available under IRC § 2058 for any state death taxes paid.[150] Upon repeal of the estate tax and adoption of the modified carryover basis rule of IRC § 1022, there is no corollary provision whereby an estate or the recipient of a decedent's property is able to offset the cost of any state death taxes. This issue may grow in importance as states review their state wealth transfer tax laws in light of the EGTRRA's changes in the treatment of state death taxes under the federal estate tax law.[151] 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.[152]

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. This proposal would prevent estate administrative expenses from remaining unused because the estate had insufficient income to offset these otherwise deductible expenses.

§ 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.

Current Law. Under IRC § 1001 and *Crane v. Commissioner*, a gift of property subject to debt is considered a realization event.[153] The law treats this type of transfer as in part a sale and in part a gift. Treas. Reg. §§ 1.1001(e) and 1.1015-4 allocate the adjusted basis in the transferred property entirely to the sale and not at all to the gift, as example 1 illustrates.

> *Example 1: A transfer of encumbered property. G* owns *Blackacre* with a fair market value of $1 million and an adjusted basis of $400,000. It is encumbered with a liability of $600,000. If *G* transfers this property subject to the debt to *B*, the tax consequences to *G* and *B* are as follows: *G* has a realized gain of $200,000 ($600,000 [amount realized] – $400,000 [adjusted basis]). *B* has a

under IRC § 2014, nonresident aliens are not allowed to claim a credit on their U.S. estate tax liability, presumably the law would limit relief in this area as well for U.S. citizens and residents. *See* Treas. Reg. § 20.2014-1(a)(1).

[150] *See* IRC § 2058(b) for the applicable period of limitations in which the estate must pay the taxes in order to claim the deduction. For further discussion of the state death tax credit and deduction, see *supra* § 3.

[151] For further discussion of the responses of the states to the phaseout of the state death tax credit and the introduction of a state death tax deduction under the estate tax, see *supra* § 3.

[152] For a discussion of the treatment of state death taxes on items representing income in respect of a decedent, see *infra* § 9.C.

[153] 331 U.S. 1 (1947). *Diedrich v. Commissioner*, 457 U.S. 191 (1982), holds that the excess of gift taxes paid by a donee over the donor's basis in the property that the donor transferred is part gift and part sale and results in taxable income.

basis of $600,000 (the amount of the debt) and a zero carryover basis for a total adjusted basis of $600,000.[154]

In 2010, when the EGTRRA repeals the estate tax and adopts the modified carryover basis rule, appreciated property encumbered by debt creates income tax problems at the death of the decedent. These problems will be associated particularly with the transfer of property encumbered by debt in excess of its adjusted basis. Example 2 illustrates the issues that can arise.

Example 2: A transfer of property encumbered with debt in excess of its adjusted basis. G owns *Greenacre*, which has a fair market value of $20 million, a zero basis, and indebtedness of $18 million. *G* makes a lifetime transfer of *Greenacre* to *B* as a part gift and part sale. She realizes a gain of $18 million ($18 million [the amount of the debt] – 0 [basis]). If the capital gain rate at the time of the transfer is 20 percent, *G*'s tax liability would be $3.6 million (20 percent x $18 million, which is more than the value of the encumbered property itself ($2 million).[155]

On the other hand, if *G* were to die in 2005 and bequeath *Greenacre* to *B, B* could sell it without realizing any gain, because, under IRC § 1014, it would have a basis equal to its fair market value at death. *G*'s gross estate would include *Greenacre* at its fair market value of $20 million, but IRC § 2053 permits the estate to deduct the debt of $18 million, and, therefore, the amount subject to the estate tax is only $2 million. *G*'s estate would owe an estate tax of no more than $940,000, based on the highest estate tax marginal rate applicable in 2005 of 47 percent (47 percent x $2 million). If *Greenacre* were subject to a nonrecourse debt, the valuation of the property itself would account for the debt, and the estate tax would remain $940,000, based on a net value of $2 million.[156]

If *G* were to die in 2010 having bequeathed *Greenacre* to *B*, the estate would owe no estate tax. Neither *G* nor *G*'s estate would incur an income tax liability upon the transfer of *Greenacre* encumbered by debt. IRC §1022(g) provides an exception to gain recognition for transfers at death of property having liabilities in excess of basis, unless the decedent or the decedent's estate transfers the encumbered property to a tax-exempt beneficiary.[157] Under the general rule of nonrecognition and IRC § 1022(g), property encumbered with debt in excess of its adjusted basis would simply retain its adjusted basis, or value if lesser, subject to the debt encumbering the property when transferred to a beneficiary. Therefore, *B* would take a zero basis in *Greenacre.* If *B* immediately were to sell the property, he would recognize a gain of $20 million. If the highest capital gain rate at the time of the sale is 20 percent, *B*'s tax liability

[154] There is no carryover basis in the reckoning of the gift, because the regulation allocates the entire basis to the sale and none to the gift. *See* Treas. Reg. §§ 1.1001(e), 1.1015-4. The tax law treats charitable contributions of encumbered property as a part sale and part gift, even when the liability does not exceed the donor's basis. Treas. Reg. § 1.1011-2(a)(3). Another regulation applies the part-sale/part-gift rule to a charitable contribution of a limited partner's interest in a partnership that is subject to a nonrecourse liability. Treas. Reg. § 1.1011-2(c)(Ex. 4) (adopting Rev. Rul. 75-194, 1975-1 C.B. 80).

[155] If the lifetime transfer occurs before 2008, the highest possible capital gain rate on *G*'s gain would be 15 percent, and *G*'s tax liability would be $2.7 million (15 percent x $18 million). Again, the tax liability would exceed *Greenacre*'s encumbered value of $2 million. For a discussion of the JGTRRA and the reduction of the capital gain rate to 15 percent, see *supra* note 24.

[156] Under IRC § 1014, nevertheless, the entire property (and not just the equity in the property) enjoys a step-up in basis to $20 million.

[157] The reason for triggering gain immediately in the event of a transfer to a tax-exempt beneficiary is that to ignore the transfer and provide a tax-exempt beneficiary a carryover basis would not defer the gain but forgive it. Accordingly, IRC § 1022(g) requires the estate, under IRC § 1001, to treat the distribution of encumbered property to a tax-exempt beneficiary as a realization event.

could be as much as $4 million (20 percent x $20 million), which is twice the value of the equity in the encumbered property itself ($2 million).[158]

As example 2 demonstrates, IRC § 1022(g) raises the question of whether, upon sale or foreclosure, a recipient of a decedent's property encumbered with debt in excess of its adjusted basis would have sufficient resources to pay the income tax liability. Or more appropriately, perhaps, the example raises the question of whether it is fair that a recipient of a decedent's property encumbered with debt in excess of its adjusted basis may potentially have an income tax liability in excess of the property's net value. The income tax is based on the individual's income, and, in taxing the recipient in this way, the tax law arguably is assessing a tax against the wrong person.

In *Taft v. Bowers*, the United States Supreme Court considered the constitutionality of the Revenue Act of 1921's gift tax carryover basis rule.[159] The taxpayer asserted that a gift was "a capital asset of the donee to the extent of its value when received and, therefore, when disposed of . . . no part of that value could be treated as taxable income . . . ."[160] The Court rejected the taxpayer's argument and upheld Congress's power to tax gains to the donee, determined by reference to the donor's basis, saying, "Congress had power to require that for purposes of taxation the donee should accept the position of the donor in respect of the thing received."[161] The Court further indicated that there is "nothing in the Constitution which lends support to the theory that gain actually resulting from the increased value of capital can be treated as taxable income in the hands of the recipient only so far as the increase occurred while he owned the property."[162]

Whether the Court today would view gain resulting from property encumbered with debt in excess of its adjusted basis as gain to a recipient in the context of IRC § 1022(g) is a fair question. Encumbered property presents a particularly difficult problem, because it is possible that decedents who previously had borrowed against their assets and had received proceeds from the borrowings escaped taxation, but the recipients of their assets at the deaths of the decedents, upon subsequent sales or foreclosures, are taxed as if they had received those proceeds. As *Corliss v. Bowers* indicates, income taxation is supposedly "not so much concerned with the refinements of title as . . . with actual command over the property taxed—the actual benefit for which the tax is paid."[163] The recipient of a decedent's leveraged property, however, may actually receive little more than mere title. A recipient subject to IRC § 1022(g), in many instances, may achieve command over a *de minimis* value and, perhaps, no value at all. In aggravated circumstances, a recipient may receive less than nothing, which is to say, a potential tax liability in excess of the equity in the asset acquired from the decedent. Even if a recipient

[158] If Congress extends the reduction of the highest capital gain rate from 20 percent to 15 percent until 2010, *B*'s tax liability would be $3 million (15 percent x $20 million). Again, the tax liability would exceed *Greenacre*'s encumbered value of $2 million. For a discussion of the JGTRRA and the reduction of the capital gain rate to 15 percent, see *supra* note 24.
[159] 278 U.S. 470 (1929).
[160] *Id.* at 481.
[161] *Id.* at 483.
[162] *Id.* at 484.
[163] 281 U.S. 376, 378 (1930).

receives some equity, that equity nevertheless may be insufficient to pay the full tax liability resulting from a subsequent sale or foreclosure. This is precisely *B*'s situation in example 2 above.[164]

Upon the transfer of property by the decedent or the decedent's estate to a transferee, IRC § 1022(g) generally disregards encumbrances on property for the purpose of determining gain.[165] This is wholly consistent with the structure of the carryover basis rule of IRC § 1022, which Congress designed to preserve unrealized gains on appreciated property and to place the tax burden for those gains on the transferee, who subsequently sells or otherwise disposes of the property. The amount realized from a sale or other disposition includes relief from indebtedness. The fact that the relief from liability may be substantial in proportion to the underlying equity in the asset should make no difference under a strict carryover basis rule. Still, some people may feel that a beneficiary inheriting leveraged property, particularly property encumbered with debt in excess of its adjusted basis, should obtain some tax relief. From the perspective of a recipient of a decedent's property, carryover basis may produce an inequitable result if the deferred tax ultimately imposed exceeds the equity in the property received.

In contrast, from the decedent's perspective, carryover basis allows the decedent to accomplish in death that which the tax law does not allow a taxpayer to accomplish during life—to avoid a realization event when transferring encumbered property. Under IRC § 1022(g), a well-advised individual owning an asset encumbered with debt in excess of its adjusted basis might establish at death a trust that holds only that encumbered asset.[166] The intended recipient can be the beneficiary of the trust. If the trust cannot pay the tax, no other person may be personally liable to make up the difference.

This strategy would allow a decedent to leave other unencumbered assets of the estate outright or to transfer those other assets into a different trust. A decedent's unencumbered assets might well include those purchased with the proceeds from the debt on the decedent's encumbered asset. By segregating the property encumbered with debt in excess of its adjusted basis into its own trust, the decedent protects the rest of the estate from the risk that the encumbered property will not ultimately be sufficient to pay the taxes on the deferred gains resulting from the debt.[167] If a decedent has many encumbered assets, the best course may be to

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[164] As example 2 demonstrates, the treatment of property subject to debt under IRC § 1022(g) can lead to harsh tax consequences, and, therefore, IRC § 1022(g) can be distinguished from the tax rule upheld by *Taft v. Bowers*. In this case, although the court required Elizabeth Taft to recognize gain that did not accrue during the time she had owned the property, she did, in fact, receive the amount realized, that is, the proceeds from the sale.

[165] Congress generally treats property encumbered with debt in excess of its adjusted basis the same as it does interspousal transfers and transfers incident to a divorce, under IRC § 1041. Arguably, the adverse tax consequences to the transferee of property encumbered with debt in excess of its adjusted basis are more fair in the context of interspousal transfers and transfers incident to a divorce than they are in the context of inheritance, because, in the marital and divorce context, both parties have the opportunity to be fully informed and to protect themselves from unexpected tax liabilities.

[166] IRC § 1022(g) clearly allows such a transfer to occur without taxation, even though the law would tax a lifetime transfer. *See* Madorin v. Commissioner, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222.

[167] The following example demonstrates the planning technique. *G* has $3 million in marketable securities in a revocable living trust. In addition, *G* owns real estate having a fair market value of $10 million and an adjusted basis of zero. *G* borrows $9.9 million, using the real estate as security, and deposits the loan proceeds into her revocable trust. She then dies leaving a will that bequeaths the real estate, subject to the indebtedness, to a separate trust. The

bequeath each asset or groupings of assets to separate trusts, on the theory that some assets will appreciate and have values in excess of their encumbrances, while others will be subject to foreclosure by lenders. When the decedent establishes separate trusts, the decedent precludes having the equity in the assets that increase in value liable for the income taxes owed upon the foreclosure of those that do not appreciate in value.[168] In other words, with careful planning, a decedent and the decedent's beneficiaries can walk away from the consequences of deferred gains. This is contrary to carryover basis, under which tax consequences are preserved in the hands of the transferees.

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.[169] It could determine the amount recoverable from each recipient based on the proportionate value of the assets each has received or another equitable method.[170] 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. The executor's election would result in an income tax liability payable from the property in the decedent's estate. The advantage to the recipients of the executor's making the election would be to protect them from potential future and unanticipated tax liabilities arising out of the right of recovery rule. Both the right of recovery rule and the deemed-realization election have the advantage of preventing a decedent from bequeathing property in a manner that isolates an encumbered asset, so as to protect the decedent's and the recipient's other property from having to contribute to the payment of the tax liability generated by the encumbrance. They also have the advantage of protecting the net worth of a recipient of a decedent's encumbered property.

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trustee of that trust sells the real estate. The sale proceeds are sufficient to discharge the $9.9 million loan, but they are insufficient to pay the tax on the gain. Though perhaps not amounting to a transfer in fraud of creditors, the segregation of the encumbered asset from the decedent's other assets has the flavor of being a fraudulent conveyance.

Recipients also may try to avoid the tax consequences of property encumbered with debt in excess of its adjusted basis by disclaiming their interests in them. *See* IRC § 2518(b). This raises the question of whether the act of disclaiming property encumbered with debt in excess of its adjusted basis constitutes a "disposition" of it for federal income tax purposes.

[168] Whether Treasury will preclude this type of planning through regulations it issues pursuant to IRC § 1022(g)(2)(D) is uncertain.

[169] Congress could model a right of recovery provision after IRC § 2207, having to do with property subject to a power of appointment that is included in a decedent's estate; after IRC § 2207A, having to do with qualified terminable interest property that is included in a surviving spouse's estate by reason of IRC § 2044; or after IRC § 2207B, having to do with property that is included in the decedent's estate by reason of IRC § 2036.

[170] Congress could further refine the allocation of liability among the recipients to take into account the potential income tax liability of each asset by comparing each asset's fair market value and 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.[171] The advantage of this alternative is that it avoids impairing a recipient's net worth with a decedent's deferred taxes. It does so, however, at the cost of immediate taxation at death.

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.[172] 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. This would prevent an estate from having the benefit of both the $1.3 million increase to the bases of the other assets and the increases to the bases of the encumbered assets. The advantage of this alternative is that it would eliminate hardships to recipients of encumbered property. It also would eliminate the potential unfairness to a recipient of encumbered property from a decedent, who may not have had sophisticated advisers to mitigate that recipient's tax liability exposure. The alternative essentially eliminates the estate planning strategy of creating separate trusts to deflect the anticipated tax liability.

The disadvantage is that the basis adjustment is the equivalent of an income exclusion for a decedent's debt, which Congress may determine fundamentally undermines the income tax base. Arguably, Congress should premise its decision to exclude gain on factors more substantial than a decedent's lifetime decision to leverage assets. Moreover, a basis adjustment rule would create an incentive for deathbed leveraging that would have more to do with tax planning or mortality calculations than with business and investment judgments and, thereby, would violate the principles of tax neutrality and tax equity.

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. One advantage of this approach is that it would eliminate the potential tax liability generated by encumbered property and, therefore, the risk to the recipient's other financial resources. Another advantage is that the government would collect a tax currently and not at some distant time in the future. Nevertheless, Congress may be reluctant to continue even a skeleton version of the

[171] For a discussion of a deemed-realization system that would apply to all of a decedent's assets at death, see *infra* Appendix A.

[172] This alternative is similar to the approach that Treas. Reg. § 1.742-1 approves as it relies on the partnership aggregation theory. The regulation states, "The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent . . . under section 691."

repealed transfer tax system for this purpose. It would seem difficult to articulate a tax policy rationale for its granting the recipient of a decedent's property an election that relies on a tax system that closely replicates one that Congress has otherwise decided to reject.

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.[173] 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. The tax avoidance test would prevent a decedent from taking undue advantage of the limitation on a recipient's tax exposure to the amount of equity in encumbered property.

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. If, however, a decedent segregates property encumbered with debt in excess of its adjusted basis in a manner that is designed to avoid paying the tax on the deferred gain, then Congress could treat the segregation as a realization event and require the decedent or the decedent's estate immediately to recognize the gain based on the difference between the amount of debt and the encumbered asset's modified carryover basis. This limited recognition rule would prevent decedents from enhancing the value of their estates by dividing their property at death for the purpose of avoiding income tax.

§ 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.

Current Law. IRC § 691(a)(1) generally requires a recipient to include in the gross income of the taxable year when received items of income that are not properly included in the taxable period in which the decedent dies or in a prior period. These items are called income in

[173] IRC § 357(b) provides an analogy to the tax avoidance limitation rule for encumbered property transferred by a decedent. It has to do with loans incurred for tax avoidance purposes or without a business purpose in anticipation of an incorporation under IRC § 351. *But see* IRC § 358(h); Temp. Treas. Reg. § 1.752-6T; Prop. Treas. Reg. §§ 1.358-7, .752-7.

respect of a decedent.[174] IRC § 691(a)(3) provides that the character of the income shall be the same in the hands of the recipient as it would have been in the hands of the decedent, if the decedent had lived and received it. IRD includes all accrued income of a cash basis decedent,[175] income accrued solely by reason of death of an accrual basis decedent,[176] and income to which the decedent had a contingent claim at his death.[177] It does not include items that the law excludes from gross income.[178]

Before and after 2010, IRC § 1014 prohibits a basis adjustment at death to items of IRD. In 2010, IRC § 1022(f) specifically prohibits the allocation of either the aggregate basis increase or the aggregate spousal property basis increase to items of IRD. The original rationale for the IRD exclusion from IRC § 1014 is that these amounts were items of accrued income of the decedent that the decedent had not recognized before death.[179]

An important and significant category of IRD is an asset held in a qualified retirement plan or IRA (plans or accounts covered by IRC § 401(a) or 408).[180] These assets frequently are a tax-favored form of retirement savings, whereby employers may make contributions to the plan or account on the behalf of their employees, and employees may agree to defer a portion of their income into a plan or account.[181] For many decedents, assets in a qualified retirement plan represent the largest proportion of their gross estates and, certainly, the largest items of IRD.

The prohibition of basis allocation to qualified retirement plans and IRAs under IRC § 1022(f) might be viewed as producing inequitable results, as the following example illustrates.

> *Example: Comparison of investments in a qualified retirement plan and after-tax investments. A* defers $100,000 over 10 years into his company's 401(k) plan. The contributions represent pretax dollars, and they grow tax free. At *A*'s death, the account is worth $1 million. In comparison, *B*

[174] The question of what constitutes IRD can lead to litigation. *See* Gavin's Estate v. United States, 113 F.3d 802 (8th Cir. 1997) (holding that the right to proceeds from grain and livestock sales under a crop sharing agreement was IRD because the right was "fully vested" at death); Kitch v. Commissioner, 103 F.3d 104 (10th Cir. 1997) (holding that alimony arrearages collected by the wife's estate from the husband's estate was IRD by virtue of the pass-through distributable net income rules). For further discussion of IRD, see M. CARR FERGUSON, JAMES FREELAND & RICHARD STEPHENS, FEDERAL INCOME TAXATION OF ESTATES AND BENEFICIARIES 139–300 (1970); NORMAN LANE & HOWARD M. ZARITSKY, FEDERAL INCOME TAXATION OF ESTATES AND TRUSTS ch. 15 (1988); John G. Steinkamp, *Identification of Income in Respect of a Decedent: The Case for Using Assignment of Income Precedents*, 46 DEPAUL L. REV. 367 (1997).

[175] Treas. Reg. § 1.691(a)-1(b)(1).

[176] Treas. Reg. § 1.691(a)-1(b)(2).

[177] Treas. Reg. § 1.691(a)-1(b)(3).

[178] Treas. Reg. § 1.691(a)-1(d).

[179] If IRC § 1014 were to apply, accrued rights to income from personal services, investment income, or similar items would escape taxation permanently. *See, e.g.*, McCarthy v. Commissioner, 9 B.T.A. 525 (1927) (a pre-IRC § 691 case holding no income to the estate upon its collection of a claim for unpaid salary that had a date of death value equal to the amount collected).

[180] *See* IRC §§ 402(a), 408(d)(1). *See also* Rev. Rul. 92-47, 1992-1 C.B. 198 (holding that the postmortem, lump sum IRA distribution constitutes IRD); Rev. Rul. 75-125, 1975-1 C.B. 254 (holding that appreciation in the employer's securities held in a qualified retirement plan is IRD upon the surviving spouse's disposition of them); Rev. Rul. 69-297, 1969-1 C.B. 131 (holding that the postmortem, lump sum distribution from the decedent's interest in a profit-sharing plan is IRD).

[181] The governmental policies favoring qualified retirement plans and IRAs can be viewed as a justification for distinguishing qualified plans from nonqualified ones.

purchases $100,000 worth of stock over a 10-year period, using after-tax funds. *B* pays tax on the dividends earned by the stock portfolio over the 10-year period. At *B*'s death, her account also has grown to $1 million. At *A*'s death, IRC § 1022(f) prohibits allocation of any of the basis increases under IRC § 1022(b) and (c) to the 401(k) plan account. *A*'s named beneficiary to the 401(k) plan receives the account balance and pays tax at ordinary income rates on the amounts distributed. At *B*'s death, *B*'s executor could allocate an additional $900,000 basis to the stock portfolio, and *B*'s beneficiaries named in her will could receive the assets with a basis equal to their fair market value.

Under principles of horizontal equity similarly situated taxpayers should be treated similarly. A decedent, such as *A*, who owned a highly appreciated qualified retirement plan account at death, could be considered as treated more harshly than a decedent, such as *B*, who owned a large portfolio of appreciated securities in an after-tax account. The treatment of the plans under IRC § 1022(f) may be particularly problematic for many taxpayers whose qualified retirement plans represent the single largest asset in their estates. By contrast, for many wealthy individuals, whose families may have accumulated significant assets over multiple generations, retirement plan assets may constitute only a small portion of their estates. Consequently, IRC § 1022(f) may have the effect of placing employees, whose assets are largely IRD items, at a disadvantage relative to wealthier individuals with after-tax portfolios, because the employees are not able to enjoy the full benefits of the basis increases that IRC § 1022 provides. Although the same fairness issues arise under IRC § 1014(c), which denies a step-up in basis to items of IRD, they seem more persuasive under IRC § 1022, because Congress can more easily tailor legislation to address both characterization and deferral issues under IRC § 1022's modification approach than under IRC § 1014's step-up in basis approach.

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. This approach would provide tax exclusion only for investment income, which would have the effect of treating assets held inside qualified plans nearly the same as assets held outside of qualified plans.[182]

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. For example, if, in 2010, the highest rate on ordinary income is 35 percent and the highest long-term capital gain rate is 20 percent, then, when an executor allocates basis modifications to assets held in qualified retirement plans and IRAs, the statute would require the executor to use a basis

[182] The difference is that the basis adjustments for growth within qualified retirement plans and IRAs would shelter not only unrealized appreciation but also accumulated dividend and interest income.

allocation at 175 percent of the rate that would otherwise apply to a basis allocation to non-IRD items. If Congress were to modify current law and extend to 2010 the highest long-term capital gain rate of 15 percent, then an executor's allocation to assets would use a basis allocation at 233 percent of the rate that would otherwise apply to non-IRD items.[183] An advantage of this approach is that it removes the incentive for executors to allocate basis increases to assets held in qualified retirement plans and IRAs to reduce the tax on ordinary income.

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. For those decedents who owned assets with significant unrealized gains outside of these types of accounts, this rule would ensure that the executor could not use the basis modifications to shelter deferred income. For those estates that consist primarily of assets held in qualified retirement plans and IRAs, this rule permits them to take advantage of IRC § 1022's basis modification provisions.

Congress could combine the requirement that an executor first allocate basis increases to assets held outside of qualified retirement plans and IRAs with the other alternatives set forth above. In cases in which basis increases are otherwise available after an executor allocates as much of the basis increases as possible to the decedent's assets that were not held in qualified retirement and IRA accounts, Congress could allow the executor to allocate basis increases for growth in the accounts. When basis increases still are available, Congress could allow the executor to allocate the remaining basis increases to assets held in qualified retirement and IRA accounts, but at an accelerated rate to reflect the fact that the deferred contributions to the accounts represent ordinary income.

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.

Current Law. IRC § 453 allows a seller, who receives an installment sale contract or promissory note from a buyer, to elect to report the recognition of gain on the installment method. If the seller dies before receiving all payments due under the installment sale contract or promissory note, the installment obligation constitutes IRD to the extent of the unreported gain.[184] That part of the installment obligation representing unrecovered basis is not IRD.[185]

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[183] For a discussion of the reduction of the capital gain rate by the JGTRRA, see *supra* note 24.

[184] IRC § 691(a)(4).

[185] For example, *G* sells a parcel of unimproved real estate to *B* for $100,000. *G*'s adjusted basis in the property is $20,000. *B* agrees to pay *G* $30,000 as a down payment and to give her a promissory note for the balance of the purchase price with installments of $10,000 per year over a period of seven years, with interest. *G* receives the down payment and the first two installments before her death. The note neither receives a step-up in basis at *G*'s death under IRC § 1014 nor modifications to basis under IRC § 1022, because the note constitutes IRD to the extent of the $40,000 of unrecognized gain, calculated as follows:

The equity arguments that can be made with respect to qualified retirement plans and IRAs also may apply to that part of an installment obligation representing gain, as the following example demonstrates.

> *Example: Installment sale immediately before death.* *G* owns a parcel of real estate that has an adjusted basis of $200,000 and a fair market value of $1 million. *G* agrees to sell the property to *B* for $1 million. *B* pays the purchase price with a promissory note payable in ten equal installments of principal over ten years, with interest accruing on the outstanding balance. *G* dies the next day. Of the $1 million promissory note, $800,000 represents gain or IRD. As *B* makes the payments each year, *G*'s beneficiaries named in his will recognize $80,000 of gain with respect to each $100,000 payment. If, however, *G* had held the real estate until death in 2010, *G*'s executor could have allocated an additional $800,000 of basis to the property, and sold the real estate to *B* in exchange for a promissory note with identical payment terms. Under these circumstances, *G*'s beneficiaries would recognize no gain with respect to each of the ten $100,000 payments.

The sale of property in exchange for a promissory note can be viewed as merely the exchange of one capital asset for another. Consequently, principles of horizontal equity arguably apply to justify treating a taxpayer who dies holding a promissory note with a face value of, say, $1 million and a basis of $200,000 the same as another taxpayer who dies holding a parcel of real estate, which also has a fair market value of $1 million and a basis of $200,000. While gains realized prior to death are clearly outside the scope of the modified carryover basis rule of IRC § 1022, installment sales demonstrate that amelioration of the distinction between realized and unrealized gains at death potentially can prevent harsh tax consequences. Deferred payments under an installment sale obligation that a decedent's beneficiaries receive after the decedent's death would seem to present a sympathetic case for Congress to consider mitigating the different tax consequences to assets with unrealized gains as opposed to assets representing deferred gains.

Alternatives

1. <u>Allow Basis Increases to the Extent of Appreciation of the Installment Obligation</u>. 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. This approach would recognize the installment note as an asset that itself is subject to changes in market value.

2. <u>Allow Basis Increases to an Installment Obligation to the Extent It Represents Unrecognized Gain</u>. 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. This approach would eliminate the distinction between an unrealized gain and a gain deferred by reason of an installment sale.

$$\frac{\text{Sales Price} - \text{Basis}}{\text{Sales Price}} \qquad \frac{(\$100{,}000 - \$20{,}000)}{\$100{,}000} = 80\%\ \text{Gross Profit Percentage}$$

Total Payments Received x Gross Profit Percentage = $50,000 x 80% = $40,000

Total Gain Realized	$80,000
Minus Total Gain Recognized	<u>$40,000</u>
IRD	$40,000

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.

Current Law. In certain cases, both the federal estate tax and the income tax apply to the same item of IRD. To ameliorate the double tax, IRC § 691(c) provides an income tax deduction for the estate tax attributable to the item of IRD subject to both taxes. In 2010, with the EGTRRA's repeal of the estate tax, IRC § 691(c) no longer is necessary. IRC § 691, however, does not provide a parallel provision for the deduction of state death taxes before 2010, in 2010, or thereafter. Also, IRC § 1022 does not allow for any adjustment to basis of items of IRD that are subject to state death taxes.

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.[186] The effect of the deduction would be to ameliorate the double taxation on an item of IRD that is subject to both the federal income tax and a state death tax.

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.

Current Law. IRC § 1022(b)(2)(C) permits an increase in the basis of assets acquired from a decedent for unused capital losses, net operating losses, and certain "built-in" losses. There are two noteworthy aspects to this provision in terms of tax precedent. First, the law previously has permitted adjustments to basis for unused losses at the death of a decedent in only limited circumstances. Second, the law does not permit an individual to shift realized or unrealized losses from one set of business or investment assets to an entirely different set of business or investment assets. In addition, before and after 2010, the law makes no adjustments for built-in losses. IRC § 1014 applies and requires the recipient of property acquired by the decedent to take a basis equal to the property's fair market value at the date of the decedent's death. The treatment under IRC § 1022(b)(2)(C), which permits an executor to increase the basis of an asset acquired from a decedent by the decedent's net operating losses and capital loss

[186] For further discussion of state death taxes, see *supra* §§ 3 and 7.2.d.

carryovers, raises the question of whether this relief provision should be extended to similar items, including losses in excess of basis under IRC §§ 704(d) (partnership) and 1366(d) (S corporation), suspended losses under IRC § 465 (at-risk rules), or suspended losses under IRC § 469 (passive activity rules).[187] IRC § 1022(h) authorizes Treasury to prescribe regulations as may be necessary to carry out the purposes of this section, raising the possibility that Treasury has authority to extend IRC § 1022(b)(2)(C) and that statutory amendment may not be necessary.

1. IRC § 1014 and Business Entities. Before and after 2010, the death of a shareholder of a C or an S corporation does not change or affect the basis of the assets inside the corporation. The stock of a deceased shareholder takes a new basis equal to its fair market value at the date of the decedent's death, under IRC § 1014.[188] For an individual owning an interest in an entity taxable as a partnership for federal income tax purposes (i.e., a partner in a partnership or a member of a limited liability company), the same rule applies, subject to two exceptions. First, a partnership may elect to adjust the basis of the partnership property to reflect the excess of the fair market value of the deceased partner's (member's) interest in partnership assets over their adjusted bases.[189] This adjustment applies only to the deceased partner's successor in interest. Second, the law requires a successor in interest's basis in the partnership to be adjusted under IRC § 752 for the decedent's share of partnership debt.[190]

2. IRD and Business Entities. Before and after 2010, IRC § 1014(c) provides that recipients of IRD items take a carryover basis. For an entity taxable as a partnership, the law treats a successor in interest as owning a pro rata share of the entity's IRD items, which includes the successor in interest's share of the partnership's zero-basis accounts receivable, as well as payments received in redemption of the decedent's interest in the partnership under IRC § 736(a).[191] For decedents owning stock in an S corporation prior to the Small Business Jobs Protection Act of 1996 (SBJPA), only the limited IRD rule for shareholders in corporations generally applies.[192] In 1996, Congress applied the partnership IRD rules to S corporations. For decedents dying after August 20, 1996, the SBJPA denies an increase in basis to the extent of a deceased shareholder's pro rata share of an S corporation's unrealized receivables.[193]

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[187] There are yet other items that Congress might want to consider. For example, under IRC § 163(d), any unused investment interest expense is lost in the event of death.

[188] A recipient's basis for each transfer of a block of stock, received either by gift or by death, is determined separately under IRC §§ 1015 and 1022. *See* Johnson v. United States, 435 F.2d 1257 (4th Cir. 1971); Downer v. Commissioner, 48 T.C. 86 (1967); Treas. Reg. § 1.333-1(e); Rev. Rul. 85-48, 1985-1 C.B. 126.

[189] IRC §§ 743(b), 754.

[190] *See* Treas. Reg. § 1.742-1 (requiring that the basis of a partnership interest in the hands of a decedent's successor be increased over its estate tax value by the successor's proportionate share of partnership liabilities).

[191] As to IRC § 736(a) payments, see IRC § 753; Treas. Reg. §§ 1.691(a)-2(a)(2), .753-1(a). As to case law treating unrealized receivables of a partnership as IRD, see Quick's Trust v. Commissioner, 54 T.C. 1336 (1970), *acq.*, 1970-2 C.B. XVIII, *aff'd per curiam*, 444 F.2d 90 (8th Cir. 1971); Woodhall v. Commissioner, T.C. Memo 1969-279, 28 T.C.M. (CCH) 1438 (1969), *aff'd*, 454 F.2d 226 (9th Cir. 1972). For taxable years ending prior to 1998, a deceased partner's distributive share of partnership income in the year of death was a third category of IRD. *See* IRC § 706(c)(2)(A).

[192] Pub. L. No. 104-188, § 1313, 110 Stat. 1755, 1785.

[193] IRC § 1367(b)(4); Treas. Reg. § 1.1367-1(j).

3. Losses of S Corporations and Business Entities Treated as Partnerships. The law permits owners of stock in S corporations or interests in partnerships to deduct their pro rata share of deductions, losses, and credits on their federal income tax returns, subject to applicable limitations. First, IRC § 1366(d) does not allow shareholders in S corporations to deduct their share of losses in excess of their bases in stock (and debt).[194] IRC § 704(d) applies the same limitation to owners of partnerships. IRC § 1366(d)(2) permits an S corporation shareholder to carry over such losses indefinitely and use them against the shareholder's distributive share of the corporation's future income.[195] A similar carryover loss rule applies to owners of entities taxable as partnerships.[196] During a shareholder's or partner's life, the law does not allow the shareholder or partner to transfer losses in excess of basis to a donee or other third party acquiring the ownership interest, even in a carryover basis transaction.[197] Any excess losses outstanding at death are unavailable for use by the decedent's estate or the successor in interest.[198]

4. At-Risk Rules. Even if an S corporation shareholder or a partner has sufficient basis to absorb pass-through deductions or losses, IRC § 465, having to do with at-risk rules, may nevertheless disallow losses. The law permits the owners to carry over indefinitely any losses that IRC § 465 disallows.[199] Prop. Treas. Reg. § 1.465-69 permits a successor in interest to have an amount at risk that includes the decedent's amount at risk in the activity plus any basis adjustment under IRC § 1014.[200] Although the statute and regulations are unclear, presumably any suspended or excess losses under IRC § 465, both before and after 2010, are personal to the taxpayer and are not transferable to successors in interest at death.[201]

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194 *See* Treas. Reg. § 1.1366-1(a)(1), -2(a)(1), (3)(i).

195 Treas. Reg. § 1.1367-2(a)(4) provides for the characterization of excess losses.

196 IRC § 704(d); 1 WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 10.05 (3d ed. 1997).

197 IRC § 704(d); Treas. Reg. § 1.1366-2(a)(5).

198 T.D. 8852, 2000-1 C.B. 253, 254; *cf.* Rev. Rul. 74-175, 1974-1 C.B. 52 (holding that there is no carryover at death of net operating losses).

199 IRC §§ 465(a)(2), 465(b)(5); Prop. Treas. Reg. § 1.465-2(b). For the characterization of such losses, see Prop. Treas. Reg. § 1.465-38 (adopting a priority-of-item approach); *cf.* Treas. Reg. § 1.469-2T(d)(6)(iii) (adopting a pro rata approach). The loss-limitation rules apply in the following order: (1) basis limitations under IRC § 1366(d) or 704(d), (2) at-risk limitations under IRC § 465(d), and (3) passive-activity loss limitations under IRC § 469.

200 Although the proposed regulation makes no cross-reference to IRC § 754, arguably the partnership must file an election under IRC § 754 in order for the decedent's successor in interest to receive the increase in the amount at risk for the IRC § 1014 basis adjustment. It is noteworthy that this proposed regulation was issued in 1979, when former IRC § 1023, which prescribed a combination "fresh start" and carryover basis rule at death, was in effect.

201 Death also may result in a recapture event under IRC § 465(e), having to do with situations in which the amount at risk in the activity is less than zero, such as when the decedent's personal liability as to certain indebtedness that generated deductible expenses is reduced or eliminated after death. IRC § 465(e)(1)(A). The amount added to income is treated as a deduction allocable to the activity in the first succeeding year and is allowed if, and to the extent that, the taxpayer's at-risk basis is increased. IRC § 465(e)(1)(B).

For a gift of an interest in a closely held company in an at-risk activity, Prop. Treas. Reg. § 1.465-68(b) provides, in effect, that the donor's positive at-risk amount is carried over and added to the donee's at-risk amount. The law also allows a further increase for the amount of gift tax paid by the donor, provided that increase does not result in a basis greater than the property's fair market value.[202] Prop. Treas. Reg. § 1.465-68(c) limits the amount by which the donee's at-risk amount may be increased. It restricts the increase to basis to the excess of the donee's basis in the stock or partnership interest at the date of transfer over the amount that the law treats the donee as having paid, which, for this purpose, includes liabilities to which the property is subject.[203] In other words, the treatment of gifts of interests in closely held companies subject to the at-risk rules is consistent with the treatment under the carryover basis rule that generally applies to lifetime transfers by gift.

The law, however, is unclear regarding transfers of part of an interest in an at-risk activity. Prop. Treas. Reg. § 1.465-68 literally applies only to transfers by gift of an owner's entire interest in the activity. For gifts of part of an interest in an at-risk activity, the proposed regulations offer no guidance. Under a carryover basis rule, an acceptable solution would seem to be to permit an allocation of the donor's pretransfer amount at risk between the portion transferred and the portion retained based on their relative values.[204]

If the donor has suspended losses under IRC § 465, Prop. Treas. Reg. § 1.465-67(b) includes those losses, as determined at the close of the taxable year in which the transfer occurs, in the determination of the donor's basis. This treatment is consistent with IRC § 1015, providing for carryover basis treatment in the case of transfers by gift.[205] The purpose of this regulation is to restore to the transferee the reduction in the adjusted basis of the transferor's interest in the gifted shares of S stock or partnership interest represented by the suspended losses under IRC § 465. It does not, however, allow donees to increase their at-risk amounts.

5. <u>Passive Activity Rules</u>. IRC § 469(g)(2) provides that suspended passive activity losses are extinguished at death to the extent that IRC § 1014 increases the estate's or the successor in interest's basis in the S stock or ownership interest. When the amount of a decedent's suspended passive activity losses exceeds the date of death basis under IRC § 1014, the excess losses are allowed as a deduction on the decedent's final return.[206] When the decedent cannot fully utilize any suspended passive activity losses on his or her final year's return, after taking into account the absorption of such losses attributable to an increase in basis caused by the application of IRC § 1014, then IRC § 469(g)(2)(B) provides that any remaining passive activity losses are not allowable in any year.

[202] IRC § 1015(d).

[203] For further discussion of the treatment of transfers by gift of property subject to debt, see *supra* § 8.

[204] *See* Rev. Rul. 84-53, 1984-1 C.B. 159 (examining the basis of a partner's general and limited partnership interest when a portion of the partnership interest is sold or exchanged).

[205] The proposed regulations further provide that the increase in the adjusted basis of the transferor's interest "is to be applied after the determination of any gain to the transferor and is to be used solely for the purpose of determining the basis of the property in the hands of the transferee." Prop. Treas. Reg. § 1.465-67(b).

[206] This rule does not, however, increase the decedent's at-risk amount. Therefore, the at-risk rules may deny a deduction for the portion of the excess losses that IRC § 469 otherwise would allow if the decedent has an insufficient amount at risk.

For a gift of an interest in a passive activity, IRC § 469(j)(6)(A) increases the donor's basis in the interest immediately before making the gift by the amount of any passive activity losses allocable to the activity for which IRC § 469(a) has disallowed a deduction. Once added to basis, the losses are not deductible in any tax year.[207] When the gift is only a part of the donor's entire interest in the property, the legislative history of IRC § 469 indicates that an allocable portion of the donor's unused losses are to be added to the donee's basis.[208]

Alternatives. In its 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 activity or 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, such as the loss suspension provisions. 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 a 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 activity or asset specific, except when taxpayers completely dispose of or terminate their interests in the activity. Under the modified carryover basis rule, it may seem inconsistent for that rule to deny basis adjustments for suspended losses and deductions while it permits basis adjustments for net operating losses or capital loss carryovers and for built-in losses in specific assets. 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. <u>Extend IRC § 1022(b)(2)(C) to Include Losses in Excess of Basis Under IRC §§ 704(d) and 1366(d)</u>. 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. The disallowances resulted from the fact that, during life, a decedent did not have sufficient basis in a partnership or an S corporation interest to be able to take a deduction, loss, or credit that had flowed through from the entity. If, however, the decedent had owned the activity directly, the suspended losses would have been currently available in computing taxable income, subject to other applicable limitations, such as the at-risk or passive activity rules. From this perspective, the losses that the law suspends because of the taxpayer's inadequate basis in interests in pass-through entities seem equivalent to net operating loss carryovers and capital loss carryovers. A taxpayer, however, can use suspended losses from pass-through entities only against the pro rata share of subsequent years' income from the particular entity in which the losses were incurred. This limitation suggests that, 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. This is to say that Congress or Treasury may not want to treat this increase in basis as the equivalent of a net operating carryover loss or capital loss carryover under IRC § 1022(b)(2)(C)(i) or a built-in

[207] IRC § 469(j)(6)(B).
[208] *See* S. REP. NO. 99-313, at 726 (1986).

loss under IRC §1022(b)(2)(C)(ii). The at-risk rules and the fair market value restriction of IRC § 1022(d)(2) presumably would limit the increase to basis.[209]

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. Congress or Treasury might use as a model Prop. Treas. Reg. 1.465-68, which has to do with the application of the at-risk rules when a taxpayer makes a lifetime gift. The result would be that the law would add a decedent's losses, which IRC § 465 suspended, to the basis of the property subject to the at-risk rules acquired from the decedent. This basis increase would be in addition to the amount of any basis increases allowable for suspended losses under IRC §§ 704(d) and 1366(d). 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. This is to say that Congress or Treasury may not want to treat this increase in basis as the equivalent of a net operating carryover loss or capital loss carryover under IRC § 1022(b)(2)(C)(i) or a built-in loss under IRC §1022(b)(2)(C)(ii).

A further question that Congress or Treasury may want to consider is whether any increase in basis for net operating losses or capital loss carryovers should result in a corresponding increase in the at-risk amount acquired by a recipient from a decedent. If they make an analogy to the tax consequences of a step-up in basis under IRC § 1014, an increase in basis under IRC § 1022(b) would increase the amount at risk.[210] If Congress or Treasury views the basis increases under IRC § 1022(b) as solely for the purpose of reducing gains associated with a recipient's disposition of property acquired from a decedent, then it likely would determine that no increase in the at-risk amount is appropriate.[211]

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. As with the preceding alternative, Congress or Treasury may not want to treat this increase in basis as the equivalent of a net operating carryover loss or capital loss carryover under IRC § 1022(b)(2)(C)(i) or a built-in loss under IRC §1022(b)(2)(C)(ii). IRC § 469(g)(2) currently provides that suspended passive activity losses are extinguished at death to

[209] If a decedent dies with suspended losses as a result of the application of IRC §§ 704(d) and 1366(d), that means the decedent's basis in an interest in a pass-through entity already was zero. The fair market value limitation accommodates the use of part or all of the previously suspended losses. If Congress and Treasury agree that increases for these suspended losses should apply only to the decedent's interest in that pass-through entity, then any "excess" amount of those suspended losses, i.e., the portion of unused losses in excess of fair market value, would not be available to increase basis for other of the decedent's interests or otherwise be treated as a net operating loss or capital loss carryover under IRC § 1022(b)(2)(C)(i) or a built-in loss under IRC § 1022(b)(2)(C)(ii).

[210] The IRC § 1014 analogy also would seem to apply to the aggregate spousal property basis increase under IRC § 1022(c). Congress and Treasury could distinguish that basis increase, however, because it is not linked to a decedent's predeath tax attributes.

[211] Congress and Treasury could take a similar view of IRC § 1022(c).

the extent that IRC § 1014 increases the estate's or the successor in interest's basis in the S corporation stock or ownership interest. Congress or Treasury may want to extend that rule to increases in basis under IRC § 1022.[212] When the amount of a decedent's suspended passive activity losses exceeds the basis determined under IRC § 1022, the excess losses could be allowed as a deduction on the decedent's final return. That rule would correspond to the treatment of passive activity losses before and after 2010.

§ 11. Aggregate Spousal Property Basis Increase

A. Qualified Spousal Property

IRC § 1022(c) provides a basis increase of up to $3 million for appreciated property passing from decedents to their surviving spouses; this is in addition to the $1.3 million aggregate basis increase provided under IRC § 1022(b). 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.[213] The additional $3 million 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.

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) qualified terminable interest property. 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. Estate Trusts

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

Current Law. Under IRC § 2056, an interest that passes from a decedent to a so-called estate trust qualifies for the marital deduction because it does not constitute a nondeductible terminable interest. An estate trust is one in which all of the income does not have to be paid to the surviving spouse at least annually, but, upon that spouse's death, all of the property then held in the trust passes to the surviving spouse's estate. The fact that the decedent had not transferred an interest in the trust to any person other than the surviving spouse, which, by reason of that transfer, that person would take possession or enjoyment of the trust property at the termination or failure of the surviving spouse's interest in the trust, makes this interest deductible under IRC § 2056. Estate trusts, however, may not meet the definition of qualified spousal property because

[212] That would include not only increases to basis under IRC § 1022(b)(2)(C) but also increases to basis under IRC § 1022(b)(2)(B) and (c).
[213] IRC § 1014.

IRC § 1022(c)(4)(A) states that outright transfer property means "any interest in property acquired from the decedent." It is possible that property acquired by a trustee on behalf of the surviving spouse might not qualify. On the other hand, the interest acquired by the surviving spouse is, in the property law sense, equal to all the property transferred into the estate trust.

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. In either case, the result would be that Congress would treat estate trusts as outright transfers. The advantage of including estate trusts as qualified spousal property is that property rules treat estate trusts as the functional equivalent of outright ownership, and the income tax law would correlate with property law.

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.

Current Law. IRC § 1022(c)(5) defines a QTIP in a manner analogous to the definition found in IRC § 2056(b)(7), which provides an exception to the estate tax marital deduction's nondeductible terminable interest rule. A QTIP is property that passes to a surviving spouse from a decedent and in which the surviving spouse has a qualifying income interest for life. IRC § 1022(c)(5)(B) defines a qualifying income interest as one in which the surviving spouse is entitled to all of the income payable at least annually or in which the surviving spouse has a usufruct interest. A further requirement of a qualifying income interest is that no person can have a power to appoint the property to anyone other than the surviving spouse. IRC § 1022(c)(5)(B), however, permits a power to persons other than the surviving spouse if it is exercisable only at or after the death of the surviving spouse. IRC § 1022(c)(5)(B) also permits an annuity to be a qualifying income interest, regardless of whether the property from which it is payable can be separately identified, to the extent provided in regulations. Unlike IRC § 2056(b)(7), IRC § 1022(c)(5) does not include an election by the executor as one of the requirements of a QTIP. Therefore, as long as the trust contains a qualifying income interest for life, the property can receive the aggregate spousal property basis increase. At least four issues arise under IRC § 1022(c)(5).

First, IRC § 1022(c)(5)(B) does not indicate whether a legal life estate is considered a qualifying income interest for life. IRC § 2056(b)(7)'s regulations recognize legal life estates for estate tax purposes.[214] This suggests that Congress probably intended that property subject to a legal life estate in a surviving spouse could receive an aggregate spousal property basis increase.

Second, recently finalized regulations would insure that if, in accordance with applicable state law, a surviving spouse has a qualifying unitrust interest in property or a trustee can exercise a power of adjustment over property and treat income as principal or principal as income, a spouse's unitrust interest would nevertheless constitute a qualifying income interest for life for purposes of the estate and gift tax marital deduction.[215] IRC § 1022(h) directs Treasury to issue regulations to carry out the purpose of the modified carryover basis rule. Pursuant to that directive, Treasury may address this issue.

Third, as under IRC §2056(b)(7), a QTIP clearly includes an interest held in trust in which, upon a surviving spouse's death, the property passes to the persons designated either by the decedent spouse or by the surviving spouse pursuant to the exercise of a nongeneral power of appointment.[216] IRC § 1022(c)(5) also apparently includes property over which the surviving spouse has a testamentary general power of appointment. This raises a fourth issue. Property over which the surviving spouse has a lifetime general power of appointment would not constitute a QTIP, because the surviving spouse has the power to appoint to anyone and not just to himself or herself. The exclusion of this type of interest can lead to harsh consequences, because the distinction between presently exercisable and testamentary general powers of appointment does not appear pertinent to whether the property passing to the spouse should qualify for an aggregate spousal property basis increase.

The surviving spouse can do three things with the lifetime power. In each instance, the operation of the presently exercisable general power of appointment produces tax results consistent with those available to property that the statute does recognize as qualified spousal property.

First, the surviving spouse can fail to appoint it. If the surviving spouse dies not having appointed the property subject to the power, the property is not eligible for any modifications to basis because it does not qualify as property having been acquired from a decedent under IRC § 1022(d)(1(B)(iii). The result, therefore, would be that the property qualifies for the aggregate spousal property basis increase at the time of the death of the first spouse but not at the death of the surviving spouse. This is the same result that occurs with regard to a QTIP. The QTIP is eligible for basis increases at the time of the death of the first spouse, but at the death of the surviving spouse the successors in interest do not receive any basis increases.[217]

Second, the surviving spouse can appoint the property to himself or herself. If the surviving spouse does so, then he or she owns the property outright. The result, therefore, would be that the property subject to the power qualifies for the aggregate spousal property basis increase at the time of the death of the first spouse and also for basis increases at the death of the

[214] *See* Treas. Reg. § 2056(b)-7(h) (Ex. 1).
[215] Treas. Reg. §§ 20.2056(b)-5, -7, .2056A-5(c)(2).
[216] IRC § 2041(b)(1) defines a general power of appointment. If a power does not fall within that definition, it is a nongeneral power of appointment.
[217] The analysis in the text assumes that Congress is not going to modify IRC § 1022's treatment of property held in a QTIP at the death of the surviving spouse. For a discussion of the treatment of a QTIP at the death of the surviving spouse, see *infra* § 11.C.

surviving spouse. This result is the same as if the spouse had received the property outright, which effectively is what happens once the spouse appoints to himself or herself.

Third, the surviving spouse can exercise the power in favor of another person. IRC § 2514 would treat such an appointment as a gift for gift tax purposes.[218] The result, therefore, would be that the property subject to the power qualifies for the aggregate spousal property basis increase at the time of the death of the first spouse, but not at the death of the surviving spouse, because it is not included in his or her estate. This result is the same as if the spouse had received the property outright and had given it away during life. In sum, the fact that a surviving spouse's general power of appointment is presently exercisable would not seem to lead to unintended tax avoidance schemes.

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. This change would have two benefits. First, it would eliminate any tax distinctions between income interests held in trust and legal life estates, which seems appropriate because they have equivalent legal and economic rights. Second, it would aid estate planners who have grown accustomed to the availability of QTIP elections for legal life estates under IRC § 2056(b)(7).

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. A trust providing a surviving spouse an income interest and certain types of general powers of appointment qualifies for the estate tax marital deduction under IRC § 2056(b)(5). There is no definitive answer to the question of whether such a trust would qualify under IRC § 2056(b)(7) as an estate tax QTIP marital deduction trust if an executor were to make the requisite QTIP election. That uncertainty causes some observers to wonder whether such a trust qualifies as a QTIP for the purpose of the basis adjustment under IRC § 1022(c). 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). The inclusion of an income interest with a lifetime general power of appointment in the definition of a QTIP does not seem to undermine the apparent goals of IRC § 1022(c). Although it represents an expansion of the aggregate spousal property basis increase, Congress's amendment of the statute would not seem to have a substantial revenue cost, because most decedents will carefully plan to assure qualification under IRC § 1022(c). The inclusion of a trust in which a surviving spouse has a presently exercisable general power of appointment in

[218] For a discussion of the continuation of the gift tax, see *supra* § 5.

the definition of a QTIP would, therefore, have the advantage of providing flexibility to estate plans and preventing the creation of drafting traps for unwary decedents who give their spouses a presently exercisable, rather than a testamentary, general power of appointment.

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.

Current Law. IRC § 1022(d)(1)(A) generally provides that the basis increases apply only to property owned by the decedent at death. Special rules apply, however, to certain property interests owned by the decedent and the decedent's surviving spouse. IRC § 1022(d)(1)(B)(i), having to do with jointly owned property, allows only the decedent's one-half interest in property owned with the surviving spouse as a joint tenant with the right of survivorship or as a tenant by the entirety to be qualified spousal property. Accordingly, only the carryover basis in the decedent's one-half interest can have any basis increases, either the aggregate basis increase under IRC § 1022(b) or the aggregate spousal property basis increase under IRC § 1022(c). Property held by a decedent and the decedent's spouse in tenancy in common is subject to the general rule, which means that IRC § 1022(d)(1) treats only the decedent's interest as owned by the decedent and available for any basis increases. Therefore, the statute treats jointly owned property and tenancies in common held by a decedent and the decedent's spouse the same.

IRC § 1022(d)(1)(B)(iv) makes the decedent's one-half interest in community property eligible for both IRC § 1022(b) and (c) basis increases. In addition, however, it makes the surviving spouse's one-half interest in community property eligible for those basis increases. Therefore, IRC § 1022(d)(1)(B)(iv) treats the decedent as owner of the entire community property interest for the purpose of determining whether it is eligible for basis increases.

IRC § 1022's treatment of jointly owned property and community property is the same as IRC § 1014's treatment. Under IRC § 1014, the entire community property interest receives a basis equal to the property's fair market value at the decedent's death. Under IRC § 1014, however, only one-half of the property the decedent jointly owned with the surviving spouse receives a basis equal to its fair market value at death.[219]

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. The result would be that the basis in the entire amount of jointly owned property would be eligible for basis increases. One advantage of making this change is that it reduces the disparate treatment that arises largely as a result of the differences in the property law of the various states. Another advantage is that it provides favorable tax treatment to married couples living in common-law states who unadvisedly hold property jointly. The disadvantage of this change is

[219] For further discussion of the treatment of jointly owned property under the estate tax, see *infra* § 23.C.

that it may encourage married couples to hold their property jointly. Moreover, the change would not eliminate the disparate treatment between married couples in common-law property states and those in community property states, because it does not affect property unless it is held jointly. Nevertheless, the prevalence of jointly owned property, especially in the estates of the moderately wealthy, may make this change attractive.

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.

Current Law. IRC § 1022(d)(1)(A) provides that, in general, basis increases under IRC § 1022(b) and (c) are available only for property that decedents owned outright at the time of their deaths. Accordingly, basis increases are available at the deaths of surviving spouses for property that they had received outright from decedents or for distributions of property that they had received from QTIP trusts. Surviving spouses' interests in QTIP trusts, however, are not eligible for basis increases at their deaths, because the surviving spouses do not own those interests outright. In addition, IRC § 1022(d)(1)(B)(iii) does not treat decedents as owning property by reason of their holding general powers of appointment over that property. Therefore, even if surviving spouses hold testamentary general powers of appointment over property held in QTIP trusts, that property is not available for basis increases upon their deaths.[220]

IRC § 1022(c)(3) equates outright ownership and a QTIP for the purpose of determining the aggregate spousal basis increase at the time the first spouse dies. IRC § 1022(d)(1), however, does not treat the two forms of bequests as equivalent in determining basis increases at the death of the surviving spouse. It is difficult to explain why one part of the statute treats these different types of bequests as equivalent, while another part does not. The disparity in treatment is even more difficult to explain when the provisions of IRC § 1022 are compared to the analogous rules found in IRC §§ 1014 and 2056. IRC § 1014, which provides a step-up in basis, applies to property that qualified for the marital deduction in the estate of the first spouse to die under IRC § 2056(b)(5), having to do with property subject to a general power of appointment, or IRC § 2056(b)(7), having to do with a QTIP. IRC § 2056 treats these types of marital deduction bequests as the equivalent of a decedent having given the surviving spouse outright ownership and, at the death of the surviving spouse, IRC § 1014 continues to treat these types of interests as the equivalent of outright ownership.

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. If Congress were to remove the disparity in treatment between property owned outright and a QTIP, it would eliminate the disparate tax

[220] For further discussion of presently exercisable general powers of appointment, see *supra* text accompanying notes 217–18.

treatment between those married couples who have the benefit of tax advisers who recommend and plan for distributions to the surviving spouses of assets comprising QTIPs and those who do not. It also would address circumstances in which the first spouses to die are reluctant to give their surviving spouses control over the ultimate disposition of bequeathed property, because the first spouses to die want to protect their descendants from prior relationships from disinheritance. Congress enacted IRC § 2056(b)(7) to allow decedents to take advantage of the unlimited marital deduction without having to relinquish control over the ultimate disposition of marital deduction property. It would be extending that policy if it were to treat a QTIP as owned at the death of a surviving spouse.[221]

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.

Current Law. IRC § 1022(d)(l)(C)(i) provides that property acquired by a decedent for less than adequate and full consideration within three years of that decedent's death does not qualify for the basis increases available under IRC § 1022(b) and (c). IRC § 1022(d)(1)(C)(ii), however, makes an exception for property acquired by a decedent from his or her spouse within three years of death, unless that spouse had received the property by gift within the three-year period. Accordingly, a husband or wife can transfer a highly appreciated asset to his or her terminally ill spouse and receive it back from that spouse with a basis that includes the basis increases provided under IRC § 1022(b) and (c). The transfers would not be subject to a gift tax because they would qualify for the gift tax marital deduction.[222] In addition, if the surviving spouse owns that previously transferred property outright, further basis increases will be available with respect to that property at that spouse's subsequent death. The exception for spousal transfers is likely to encourage deathbed planning to assure that the decedent's estate can take full advantage of basis increases that might otherwise be lost had the surviving spouse not made gifts of appreciated assets to the decedent near the decedent's death.

IRC § 1022(d)(1)(C)(ii) treats property acquired by a decedent from a spouse more favorably than IRC § 1014 does. Although IRC § 1014(e) adopts only a one-year rule, rather than a three-year rule, it applies to transfers between spouses. If a decedent acquired property from his or her spouse within one year of death and bequeathed that property back to that spouse, the spouse does not receive a step-up in basis equal to the property's fair market value at the decedent's death.

[221] If Congress were to adopt the proposal to treat property over which a surviving spouse holds a presently exercisable general power of appointment as qualified spousal property, then, at the surviving spouse's death, it could extend the proposal and treat that property subject to a presently exercisable power of appointment as owned for purposes of IRC § 1022(d)(1). *See supra* § 11.A. Congress would not necessarily have to repeal IRC § 1022(d)(1)(B)(iii), having to do with powers of appointment, but could make an exception only for property subject to general powers of appointment that had constituted qualified spousal property in the estate of the first spouse to die.

[222] For further discussion of the continuation of the gift tax, see *supra* § 5.

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. Congress's purpose in adopting the basis increases was to place most moderately wealthy married couples in the same position they would have been in under the estate tax/step-up in basis rules. The exception places married couples in a better position by allowing them to take advantage of basis increases by engaging in deathbed transfers from one spouse to the other that are not available to them under IRC § 1014(e). An advantage of Congress's eliminating the exception is that it would prevent differential treatment of couples who obtain planning advice near the time that the first spouse dies and those who do not.

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.

Current Law. IRC § 1022(b)(3) provides that the aggregate basis increase amount for property acquired from a noncitizen decedent who is a nonresident is $60,000, instead of the $1.3 million provided in IRC § 1022(b)(2)(B). IRC § 1022(c), having to do with the aggregate spousal property basis increase, does not address the question of noncitizen decedents who are nonresidents. The difference in treatment of the two types of basis increases may be related to the purpose of the aggregate spousal basis property increase and that subsection's treatment of noncitizen spouses who are nonresidents.

IRC § 1022(c) also does not address the question of whether the full $3 million aggregate spousal property basis increase is available for property passing to a surviving spouse who is a nonresident, whether or not that spouse is a U.S. citizen. IRC § 2056 distinguishes between transfers to citizen and noncitizen surviving spouses. The purpose of the qualified domestic trust (QDOT) rules under IRC §§ 2056(d) and 2056A is to prevent a surviving noncitizen spouse from receiving property tax free by operation of the marital deduction and then leaving the United States with such property, so that it escapes estate tax all together. The QDOT rules reflect Congress's general goal to prevent tax forgiveness, but to allow only deferral of the estate tax until the death of the surviving spouse. In contrast, the aggregate spousal property basis increase does represent tax forgiveness to the extent of the $3 million basis adjustment. The fact that the surviving spouse may not be subject to U.S. income tax upon the sale of an asset makes no difference because the aggregate spousal property basis increase already assures that result for all spouses.

IRC § 6018(b)(3), as amended by the EGTRRA and effective in 2010, is unclear, however, whether the aggregate spousal property basis increase is available for assets acquired by all nonresident spouses who are not citizens. IRC § 6018 generally has to do with information returns that an executor must file regarding property acquired from a decedent in 2010. IRC §

6018(b)(3) provides that the only property acquired from a nonresident decedent who is a noncitizen that is to be included on the return is tangible property situated in the United States and property acquired by a U.S. person. IRC § 7701(a)(3) defines a U.S. person to be a citizen or resident of the United States or a trust that meets the requirements of IRC § 7701(a)(30)(E). Under IRC § 6018(b)(3), it seems that Congress may have contemplated that the aggregate spousal basis increase for property, other than tangible property situated in the United States, is available only for property passing to a surviving spouse who is a citizen or resident of the United States or to a QTIP trust that is considered a U.S. person.

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. The issue arises because of the differences in the qualification rules for the aggregate spousal property basis increase under IRC § 1022(c) and in the requirements for filing a return under IRC § 6018(b)(3), having to do with decedents who are noncitizens and nonresidents.

§ 12. Allocation of Basis Increases

IRC § 1022(d)(3)(A) authorizes an executor to allocate to appreciated assets the basis increases, which are described in IRC § 1022(b) and (c). IRC § 6018, as amended and effective for estates of decedents dying after 2009, requires the executor to report that allocation on an information return.[223] IRC § 6018 applies only to "large transfers," which it defines as "all property (other than cash) acquired from a decedent if the fair market value of such property acquired . . . exceeds the dollar amount applicable under section 1022(b)(2)(B)," that is, $1.3 million, as further adjusted for inflation.[224] Except for IRC § 1022(d)(3)(B), authorizing Treasury to provide guidelines for changing an allocation, IRC §§ 1022 and 6018 leave unaddressed many issues about 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.

[223] IRC § 7701(a)(47), which the EGTRRA adds and which applies to estates of decedents dying after 2009, defines an executor to mean "the executor or administrator of the decedent, or, if there is no executor or administrator appointed . . ., then any person in actual or constructive possession of any property of the decedent."

[224] IRC § 6018(b). With respect to nonresident aliens, IRC § 6018(b)(3) provides that the applicable dollar amount is $60,000 (adjusted for inflation). It applies only to tangible property situated in the United States or other property acquired from the decedent by a "United States person." IRC § 7701(a)(30) defines a United States person to include a citizen or resident of the United States and a trust if "a court within the United States is able to exercise primary supervision over the administration of the trust" and "one or more United States persons have the authority to control all substantial decisions of the trust."

Current Law. IRC § 1022(d)(3)(A) authorizes an executor to allocate basis increases. It does not, however, require the executor to allocate the basis increases in accordance with a decedent's directives contained in a will or other governing instrument.[225] State law establishes the executor's fiduciary duty in the exercise of a power of allocation, and state law would generally treat the decedent's directives as controlling. Even if Congress were to amend the statute or Treasury were to provide regulations that acknowledge that the decedent's directives regarding allocation of basis increases are controlling, drafting problems would remain.

Planners are likely to have difficulty drafting formula clauses that are unambiguous. For example, a decedent's will that provides for the surviving spouse to receive such assets as will maximize the $3 million exemption may not provide the executor with sufficient guidance, depending on the carryover basis and fair market value of each of the assets in the estate. For instance, the executor could select assets having an aggregate date of death value of $4 million and an aggregate carryover basis of $1 million, or property having an aggregate date of death value of $6 million and an aggregate carryover basis of $3 million. In both cases, the executor would have satisfied the formula. The value of the property passing to the surviving spouse and the decedent's other beneficiaries differs significantly, however, depending on which allocation the executor adopts. Admittedly, in the example, the decedent could have refined the formula. The will provision could have directed the executor to minimize the value of the property passing to the surviving spouse, while still maximizing the use of the $3 million basis increase provided by IRC § 1022(c). The problem with the executor's applying this type of formula is that it may not further the decedent's intent, especially if repeal of the estate tax is permanent, which would reduce, if not eliminate, any concerns of trying to minimize the wealth transfer tax consequences to the surviving spouse.

Alternatives

1. <u>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</u>. 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. In effect, beneficiaries would have a specific amount of basis increase to allocate among their own assets as they deem appropriate. The limitation of IRC § 1022(d)(2) would still apply, and no allocation could result in a basis that exceeds the assets' fair market value at the time of the allocation. The decedent's directives set forth in governing instruments would be easier to draft under this approach. Under this alternative, however, the reporting requirements of IRC § 6018 may be difficult to meet.

[225] A decedent's directive might consist of a tax-driven formula, or it might refer to specific assets or specific recipients of property. For example, decedents might direct their executors to allocate the aggregate basis increase of $1.3 million first to the assets that their children acquire and then to the assets that their grandchildren acquire. Alternatively, decedents may direct their executors to allocate the basis increases first to their closely held businesses.

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. This approach more closely relates the basis allocation to the value of the property acquired from the decedent. It still has the advantage, however, of relieving the executor from having to assure that the beneficiary received sufficiently low-basis property to utilize the basis increase. Also, this approach is not likely to create many uncertainties or litigable issues or to complicate the drafting of the decedent's directives.

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. Under this approach, the executor would need to consider the carryover basis of an asset when making allocations of assets and basis increases. Its advantage is that it relates the basis increases directly to the decedent's assets. Its disadvantage is that it is likely to generate complex formulas in donative instruments, uncertainties, and litigation among executors and beneficiaries of decedents' estates.

B. A Default Rule

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

Current Law. In general, Congress does not address the problem of an executor's failure to allocate the basis increases.[226] Absent legally binding direction from the decedent, the fiduciary's duty of impartiality under applicable state law would provide the parameters for determining how to allocate the basis increases, if the executor fails to do so.[227] If a decedent's property is located in more than one jurisdiction, the law of more than one state might apply, thereby raising conflicts of law problems.[228] Congress could avoid reliance on state laws in this area by providing its own default rule.[229] A default rule can further simplify and minimize tax

[226] IRC § 6018(b)(4) provides for the situation in which an executor is unable to make a complete information return because some property is in the hands of a trustee or a beneficiary.
[227] For a discussion of the duty of impartiality, see RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 (1992) (providing a prudent investor standard), *modifying* RESTATEMENT (SECOND) OF TRUSTS § 183 (1959); GEORGE G. BOGERT ET AL., THE LAW OF TRUSTS AND TRUSTEES: A TREATISE COVERING THE LAW RELATING TO TRUSTS AND ALLIED SUBJECTS AFFECTING TRUST CREATION AND ADMINISTRATION § 612 (3d ed. 2000).
[228] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 145 (1971).
[229] Allocation of the basis increases is not the kind of issue upon which Congress should rely on state law, because it has to do with providing tax benefits to taxpayers. *See Bixby*, 295 P.2d at 74–76. *In re* Warms' Estate, 140 N.Y.S.2d 169 (Surr. Ct. 1955); Michael D. Carrico & John T. Bondurant, *Equitable Adjustments: A Survey and Analysis of*

inequities, if Congress designs it to achieve an approximation of an allocation that a decedent would have directed had that decedent had the advantage of tax advice.

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.[230] A default rule would apply only if the decedent fails to direct an allocation and the fiduciary fails to make an allocation. The advantage is that it can achieve an approximation of an outcome that dutiful fiduciaries, who are exercising their discretion skillfully, would achieve.

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.

Current Law. Presumably, an executor can allocate the IRC § 1022(b) aggregate spousal property basis increase to assets that the executor sells to meet administrative expenses and state tax liabilities. A question arises as to whether an executor also can allocate the aggregate spousal property basis increase to assets that the executor sells during administration. The answer would seem to be no, because IRC § 1022(c) makes the aggregate spousal property basis increase available only with respect to property that a surviving spouse acquires outright or in a QTIP trust. This result is in accord with the current estate tax law, which permits a marital deduction only for property actually passing to a surviving spouse.[231] The executor's inability to allocate the aggregate spousal property basis increase to assets that the executor sells during administration can work to the detriment of the surviving spouse. For example, the restriction may force the executor to choose between selling assets that have little or no appreciation so as to reduce the estate's income tax liability and more highly appreciated assets that business, investment, or family considerations indicate would be more preferable to sell, except for the fact that their sale would result in a higher income tax liability to the estate. If the surviving spouse is the primary beneficiary of the decedent's estate, whichever choice the executor makes, the sales of estate assets harm that spouse financially.

Precedents and Practice, 36 TAX LAW. 545 (1983); Joel C. Dobris, *Equitable Adjustments in Post-Mortem Tax Planning: An Unremitting Diet of Worms*, 65 IOWA L. REV. 103 (1979).

[230] Treas. Reg. § 1.755-1(b)(2).

[231] Treas. Reg. § 20.2056(b)-4(c), (d).

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. Either approach would further Congress's goal, which IRC § 1022(c) reflects, of reducing the income tax consequences of the carryover basis rule for surviving spouses.

§ 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.

Current Law

1. Reporting Requirements Under IRC § 1022. IRC § 1022(d)(3)(A) requires an executor to allocate the basis increases to a decedent's assets. The executor is to make the adjustments on an asset-by-asset basis. IRC § 1022(d)(2) limits any basis adjustment to an asset to that amount that, when added to the decedent's adjusted basis, does not exceed that asset's fair market value, presumably determined at the date of the decedent's death. IRC § 1022(d)(3)(B) provides that executors may change any allocation previously made only if they comply with the procedures that Congress directs Treasury to establish.[232]

IRC § 6018, as amended by the EGTRRA and effective in 2010, requires an executor to file an information return for transfers at death of noncash assets in excess of $1.3 million.[233] In addition, IRC § 6018(b)(2) requires an executor to report any appreciated property included in the decedent's estate that the decedent had acquired by gift within the three years preceding the death of that decedent. This reporting requirement applies only if the donor of that appreciated

[232] IRC § 1022(h) provides that Treasury may issue regulations to carry out the purposes of this subsection, including the applicable rules pertaining to the allocation of basis increases.

[233] For noncitizen decedents who are not residents, IRC § 6018(b)(3), as amended by the EGTRRA and effective in 2010, modifies the reporting requirements. It requires the filing of an information return for transfers of tangible property situated in the United States and other property acquired from the decedent by a U.S. person, but only if those transfers exceed $60,000.

The legislative history indicates that the trustee of a revocable trust also may have the responsibility for filing the information return. *See* H.R. CONF. REP. NO. 107-84, at 185 (2001). Treasury, either by regulation or similar guidance, can be expected to address the situation in which a pour-over will to a trust may result in the trust holding all or nearly all of the decedent's assets and indicate whether the trustee or the executor primarily is responsible for making the basis increase allocations and filing the information return.

property had to file a gift tax return.[234] If executors are unable to provide all the information required with respect to a given property, IRC § 6018(b)(4) requires that they include a description of that property and the name of every person holding a legal or beneficial interest in that property on the return. It further requires that, upon notice from the IRS, the owners of the property file an information return.[235] IRC § 6075(a), as amended by the EGTRRA and effective in 2010, requires the executor to file the IRC § 6018 information return with the decedent's final income tax return or at a later date that Treasury may specify by regulation.

IRC § 6018(c) requires the executor to provide the following information with respect to any property acquired from the decedent: (i) the name and taxpayer identification number of the recipient of the property; (ii) a description of the property; (iii) the adjusted basis of the property in the hands of the decedent and its fair market value at the time of death; (iv) the decedent's holding period in the property; (v) information regarding the character of the property, such as whether the decedent held it for investment or whether the recapture rule might apply; (vi) the amount of basis increase the executor allocated to the property under IRC § 1022(b) or (c); and (vii) other information that Treasury may require by regulation.

IRC § 6716, added by the EGTRRA and effective in 2010, imposes penalties on the executor for failure to furnish the information required by IRC § 6018. IRC § 6716(b) penalizes the executor $50 for each failure to report the required information to beneficiaries.[236] If the executor fails to file the IRC § 6018 information return in a timely manner, IRC § 6716(a) imposes a penalty of $10,000 for each such failure. If, however, the executor fails to furnish information regarding gifts made to the decedent within three years of death, IRC § 6716(a) imposes a $500 penalty for each such failure. IRC § 6018(c) permits an executor to avoid the penalties upon a showing of reasonable cause. If a failure to report to the IRS or to a beneficiary is intentional, however, IRC § 6716(d) increases the penalty to 5 percent of the fair market value of the property for which IRC § 6018 required reporting.[237]

2. Reporting Requirements Under the Estate Tax/Step-up in Basis Rules. IRC § 6018, unamended and effective before and after 2010, requires an estate to file an information return if

[234] IRC § 6019 does not require a gift tax return for a transfer that qualifies for the annual exclusion under IRC § 2503(b), the educational and medical exclusion under IRC § 2503(e), or the marital deduction under IRC § 2523.

[235] The EGTRRA also amended IRC § 6019, having to do with gift tax returns, by adding IRC § 6019(b). This subsection requires that, within 30 days of filing a gift tax return, each donee must receive a copy of the information included in the return. The effective date of this provision is uncertain. According to EGTRRA § 542(f)(1), estate tax repeal applies to estates of decedents dying after 2009. The Act does not state that the amendment to IRC § 6019 applies to taxable gifts that donors make after 2009.

[236] IRC § 716(b) also imposes the same $50 penalty on the individual responsible for providing the donee of a taxable gift the information required under IRC § 6019(b), amended by the EGTRRA and effective after 2009. For further discussion of the effective date, see *supra* note 235.

[237] The exception for reasonable cause under IRC § 6716(c) and the additional penalty for intentional disregard under IRC § 6716(d) also apply to the reporting requirements for gifts under IRC § 6019.

IRC § 6716(d) determines the fair market value at the time of the decedent's death for computing the penalty for intentional disregard of the reporting requirements under IRC § 6018. It also determines the fair market value at the date of the gift for computing the penalty for intentional disregard of the reporting requirements under IRC § 6019.

the value of the gross estate exceeds the applicable exclusion amount.[238] As part of such filing to the IRS, the law generally requires the executor to submit information to recipients on the reported and finally determined estate tax value of the property that they have received. In accordance with IRC § 1014, that value is the basis of the property in the hands of the recipient. Whether the recipients are individuals or trustees holding the property in trust, they rely on the information the executor provides.

3. Resolution of Basis Disputes. Under the estate tax/step-up in basis rules, the question frequently has arisen as to whether the law estops recipients from challenging the reported or finally determined value of assets for federal estate tax purposes, when they subsequently determine their federal tax liability on later sales or other dispositions of those assets. Resolution of disputes in this area involves consideration of several long-standing rules of tax procedure, as well as the intervention of the statutory mitigation provisions. Although the estate tax/step-up in basis rules establish a recipient's basis in property by reference to that property's estate tax value and the modified carryover basis rule relies primarily on a decedent's adjusted basis as statutorily modified, the desired end product is the same, i.e., the determination for income tax purposes of the recipient's basis in an asset acquired from the decedent. Therefore, presumably the same norms and rules used by the courts for many years in resolving basis disputes involving property acquired from a decedent will apply with equal vigor to the modified carryover basis rule.

a. Presumptions for Determining Basis Under IRC § 1014. Treas. Reg. § 1.1014-3(a) presumes that the fair market value used for estate tax purposes is the same value that determines a recipient's basis in an asset for income tax purposes. If an executor does not have to file an estate tax return under IRC § 6018, which the EGTRRA does not change and which remains in effect before and after 2010, Treas. Reg. § 1.1014-3(a) presumes that the fair market value used for the purpose of determining state inheritance or transmission taxes is the same value that determines a recipient's basis in an asset for income tax purposes. In the absence of a filing, the law presumably would require the recipient to establish fair market value by appraisal.[239] The

[238] IRC § 6018(a)(3), unamended by the EGTRRA and effective before and after 2010, adjusts the applicable exclusion amount by the amount of the adjusted taxable gifts that the decedent had made after 1976 and by the aggregate amount allowed as a specific exemption under IRC § 2521, which the Tax Reform Act of 1976 had repealed and which applied to gifts the decedent made after September 8, 1976.

[239] *See* Burnet v. Houston, 283 U.S. 223, 228 (1931) (holding that the taxpayer bears the burden of proving the fair market value of property as of the effective date of the federal income tax in order to establish a claim for a deductible loss, regardless of the difficulty that may arise in meeting such a burden); Biltmore Homes, Inc. v. Commissioner, 288 F.2d 336, 342 (4th Cir. 1961), *aff'g* T.C. Memo. 1960-53, 19 T.C.M. (CCH) 268 (holding that the taxpayer failed to meet its burden of proving a higher basis in homes constructed for sale to customers). *See also* Welch v. Helvering, 290 U.S. 111 (1933) (presuming the correctness of a deficiency notice); Albino v. Commissioner, 273 F.2d 450 (2d Cir. 1960) (*per curiam*) (holding that the taxpayer failed to meet his burden to establish greater beginning net worth under the cash expenditures method of reporting income); TAX CT. R. 142(a) (placing the burden of proof generally on the taxpayer but shifting the burden when the taxpayer produces credible evidence regarding tax liability). *But see* Cinelli v. Commissioner, 502 F.2d 695 (6th Cir. 1974) (determining the basis in an Italian villa inherited during WWII); Jones v. Commissioner, 24 T.C. 525 (1955), *acq.*, 1955-2 C.B. 3 (estimating the donor's cost basis of a diamond pin later claimed as a deductible theft loss); Pleason v. Commissioner, 22 T.C. 361 (1954), *acq.*, 1954-2 C.B. 3, *aff'd*, 226 F.2d 732 (7th Cir. 1955) (rejecting the figures in a deficiency notice).

courts have held that this regulation creates a *prima facie* presumption of fact. A taxpayer seeking to use a different value for basis in a subsequent transaction may, however, rebut the presumption with convincing evidence.[240]

b. The Duty of Consistency. The IRS has agreed that taxpayers, whose prior actions or statements do not estop them, may rebut the presumption that the reported value of property for federal (or state) estate tax purposes is correct by their proffering clear and convincing evidence to establish a higher basis for income tax purposes.[241] Based on the judicial doctrine of a taxpayer's duty of consistency—quasi-estoppel—the IRS maintains that a taxpayer who previously made the representation of value may not later change positions. This doctrine binds taxpayers to prior representations that they have made to which the IRS has acquiesced or upon which the IRS has relied and for which the statute of limitations bars any adjustment.[242] Specifically, the duty of consistency applies when the following three conditions are met: (i) the taxpayer has made a representation or reported an item for tax purposes in one year, (ii) the IRS has acquiesced to or relied upon the representation or filing for that year, and (iii) the taxpayer desires to change the prior representation for a year after the statute of limitations on assessments bars adjustments for the prior year.[243]

The critical question in this area is whether a recipient of property acquired from a decedent may avoid the duty of consistency doctrine. The duty of consistency can bind recipients to representations that they have made on estate tax returns in their fiduciary capacities. Moreover, courts have applied the doctrine when an executor and a taxpayer are in privity with one another. Whether there is sufficient identity of interests between the parties to apply the duty of consistency depends on the facts and circumstances of each case.[244] The courts have based

Under IRC § 7491, the burden of proof regarding a particular issue shifts to the government in any court proceeding in which an eligible taxpayer, e.g., an individual or estate, introduces "credible evidence" on the issue, has complied with all applicable substantiation and record-keeping requirements, and has fully cooperated with the IRS's reasonable requests for information, witnesses, documents, etc., during the audit and ensuing tax controversy. Tax Ct. R. 142(a)(2). *See also* IRC § 1312(7) (mitigating the statute of limitations for prior erroneous treatment of basis); Chertkof v. United States, 676 F.2d 984 (4th Cir. 1982) (applying the mitigation provision regarding a question of basis to an estate).

[240] McEwan v. Commissioner, 241 F.2d 887 (2d Cir. 1957); Plaut v. Munford, 188 F.2d 543 (2d Cir. 1951); Sam T. McIntosh v. Commissioner, T.C. Memo. 1967-230, 26 T.C.M. (CCH) 1164.

[241] Rev. Rul. 54-97, 1954-1 C.B. 113.

[242] Stearns v. United States, 291 U.S. 54 (1934); Alamo Nat'l Bank v. Commissioner, 95 F.2d 622 (5th Cir. 1938); Mayfair Minerals, Inc. v. Commissioner, 56 T.C. 82 (1971), *aff'd*, 456 F.2d 622 (5th Cir. 1972).

[243] *See, e.g.*, Beltzer v. United States, 495 F.2d 211 (8th Cir. 1974), *aff'g* 32 A.F.T.R.2d 73-5250 (D. Neb.) (applying the duty of consistency doctrine against a taxpayer who was the coexecutor of the decedent's estate); LeFever v. Commissioner, 103 T.C. 525 (1994), *aff'd*, 100 F.3d 778 (10th Cir. 1996) (binding the taxpayer to filing of the special use valuation election under IRC § 2032A(a)). If the statute of limitations for federal estate tax purposes is still open at the time that the IRS is reviewing a subsequent transaction, the doctrine of quasi-estoppel may not prevent the taxpayer from taking a position inconsistent with a previous representation. *See* Pa. Co. for Banking & Trusts, 51-2 U.S.T.C. ¶ 9392 (E.D. Pa. 1951).

[244] Hess v. United States, 537 F.2d 457 (Ct. Cl. 1976), *cert. denied*, 430 U.S. 931 (1977) (extending the duty of consistency doctrine to a testamentary trust whose trustees were the executors of the estate and barring the use of a value for basis for the purpose of reporting the tax consequences of a redemption that is higher than the value of the stock reported for federal estate tax purposes).

privity on a fiduciary's duties to the taxpayer or on a sufficiently close relationship between the party making the prior representation and the party claiming a position inconsistent with the one that the executor reported for federal estate tax purposes.[245] They have also found privity between the estates of a husband and a wife.[246] The courts, however, have permitted a recipient, who did not serve as the executor of the estate, to establish a value for income tax purposes other than the value previously reported for estate tax purposes.[247]

Although taxpayers are subject to a duty of consistency in reporting tax items in different years, the duty of consistency does not apply to the government. The IRS's acceptance of an estate tax return does not bind it for purposes of determining basis under IRC § 1014, even when it audited the estate tax return. In other words, unless a deficiency or refund case makes a final adjudication of the value of the decedent's property at death, or the estate and the IRS enter into a formal closing agreement regarding the basis of one or more estate assets, the IRS is free to make an independent determination of an asset's date of death value for the purpose of determining that asset's basis for income tax purposes.[248]

c. The Doctrine of Election. A concept related to a taxpayer's duty of consistency is the doctrine of election, which, in general, treats as irrevocable a taxpayer's election on a tax return.[249] The doctrine of election, as it applies to federal tax law, consists of two elements: (i) there must be a free choice between two or more alternatives, and (ii) there must be an overt act by the taxpayer communicating the choice to the Commissioner, i.e., a manifestation of the taxpayer's choice.[250] Various transfer tax provisions codify the doctrine of election.[251]

[245] *See*, *e.g*., Estate of Letts v. Commissioner, 109 T.C. 290 (1997) (estopping the wife's estate from asserting that a trust did not qualify for QTIP treatment).
[246] *See*, *e.g*., Cluck v. Commissioner, 105 T.C. 324 (1995) (applying estoppel because the taxpayer's spouse was the executor and the spouses had filed joint tax returns for the years at issue).
[247] *See*, *e.g*., Shook v. United States, 713 F.2d 662 (11th Cir. 1983) (refusing to estop the beneficiary of an estate for merely having indicated approval of the executor's handling of the estate over which the executor had total control); Ford v. United States, 276 F.2d 17 (Ct. Cl. 1960) (refusing to estop the decedent's minor beneficiaries who were residing outside of the United States from establishing a different value for inherited stock because they were not fiduciaries of the decedent's estate and had no knowledge of the decedent's estate tax return).
[248] *See* Commissioner v. Sunnen, 333 U.S. 591 (1948) (distinguishing res judicata and collateral estoppel for tax litigation purposes); Wiltse v. Commissioner, 51 T.C. 632 (1969) (holding res judicata and collateral estoppel barred the taxpayer from relitigating in a subsequent case the determination and character of his distributive share of partnership income). *See also* IRC § 7121 (having to do with closing agreements); Cramp Shipbuilding Co. v. Commissioner, 17 T.C. 516 (1951), *acq*., 1954-2 C.B. 3, *aff'd per curiam sub nom*. Harriman, Ripley & Co. v. Commissioner, 202 F.2d 280 (3d Cir. 1953) (affirming the Tax Court's finding that the closing agreement, which had to do with the taxpayer's depreciation method, was binding on the Service). *Cf*. IRC §§ 1311–1314 (having to do with mitigation of the effect of limitations and other provisions).
[249] *See* Pac. Nat'l Co. v. Welch, 304 U.S. 191 (1938); Roy H. Park Broad., Inc. v. Commissioner, 78 T.C. 1093 (1982); Stamos Estates v. Commissioner, 55 T.C. 468 (1970); Woodbury v. Commissioner, T.C. Memo. 1988-272, 55 T.C.M. (CCH) 1131, *aff'd*, 900 F.2d 1457 (10th Cir. 1990).
[250] *See* Bayley v. Commissioner, 35 T.C. 288, 298 (1960), *acq*., 1961-2 C.B. 3; Burke & Herbert Bank & Trust Co. v. Commissioner, 10 T.C. 1007, 1009 (1948).
[251] *See*, *e.g*., IRC §§ 2032(d)(1) (alternate valuation), 2032A(d)(1) (special use valuation), 2056(b)(7) (qualified terminable interest property under the estate tax marital deduction), 2624(b) (application of elections under IRC §§ 2032, 2032A(d)(1) to the generation-skipping tax), 6166(d), (h) (extension for payment of the federal estate tax). *Cf.*

IRC § 1022(d)(3)(B) provides that once executors make allocations of basis increases among qualifying assets, they may change those allocations only as Treasury provides. The doctrine of election will undoubtedly influence the IRS to adopt the position in future regulations that an executor's allocation of basis increases to specific assets is irrevocable.

d. The Mitigation Provisions of IRC §§ 1311–1314. Both the IRS and the taxpayer can invoke the mitigation provisions contained in IRS §§ 1311 through 1314 to correct or prevent one of them from taking a position inconsistent with a previous position maintained for an earlier tax year, after the applicable statute of limitations for that earlier year has expired. The mitigation provisions apply if four requirements are met. First, IRC § 1311(a) requires a determination, in accordance with IRC §1313, establishing an error in a prior year.[252] Second, the error must be one that falls within one of the circumstances of adjustment, which IRC § 1312 describes. Third, IRC § 1311(a) requires that res judicata or other rule of law apply to prevent correction of the error on the date of the determination of error. Fourth, IRC § 1311(b) requires, as the case may be, that the IRS's current position be inconsistent with the position determined to be erroneous or that the taxpayer's current position be inconsistent with the position determined to be erroneous.[253]

IRC § 1312(7) addresses the basis issue. It imposes the following four additional requirements before permitting a correction: (i) the determination must concern the basis of the property;[254] (ii) the determination also finds that an error was made with respect to the treatment of a prior transaction (for a barred year) on which the property's basis depends or on a transaction that erroneously was treated as affecting its basis;[255] (iii) the error must have

IRC §§ 643(e)(3) (recognition of gain on the distribution of property from a trust), 645 (revocable trusts treated as part of an estate).

[252] *See* Hill v. Commissioner, T.C. Memo. 1957-2, 16 T.C.M. (CCH) 11 (holding that the taxpayer's motive to obtain an adverse Tax Court decision was sufficient to meet the "determination" requirement under IRC § 1313(a)).

[253] The strict requirements of the mitigation provisions limit the circumstances under which the previous erroneous treatment of an item in a barred year can be corrected. *See* United States v. Rushlight, 291 F.2d 508, 514 (9th Cir. 1961); Olin Mathieson Chem. Corp. v. United States, 265 F.2d 293, 296 (7th Cir. 1959); Bolten v. Commissioner, 95 T.C. 397, 403 (1990); Bradford v. Commissioner, 34 T.C. 1051, 1054 (1960); Brennen v. Commissioner, 20 T.C. 495, 500 (1953).

Collateral requirements include that the determination must adopt a position maintained by a particular party, and the position adopted must be inconsistent with the erroneous treatment. A further requirement is that the mitigation provisions must be invoked in a timely manner. IRC § 1314(b); Treas. Reg. § 1.1314(b)-1(b).

[254] IRC § 1312(7)(A). In *Central Hanover Bank & Trust Co. v. United States*, 163 F.2d 60 (2d Cir. 1947), the personal representative of an estate sought relief under the mitigation provisions concerning the decedent's sale of a block of stock in 1936. She had calculated basis on an average cost per share approach. The decedent reported gain from the sale of additional shares in the same manner in the preceding year. The government required an adjustment for 1935, contending that basis must be calculated on a first-in/first-out (instead of average cost) basis. This resulted in a deficiency for 1935, but it had the further effect of reducing the size of a reported loss for 1936 with respect to the sale of the additional shares. Still, the Second Circuit held that the determination with respect to 1935 did not determine basis for the succeeding year, even though the effect of the decision would have produced a "double tax" effect to the same taxpayer. *See* Gooding v. United States, 326 F.2d 988 (Ct. Cl. 1964); Rosenberger v. United States, 138 F. Supp. 117, *aff'd*, 235 F.2d 69 (8th Cir. 1956); Sherover v. United States, 137 F. Supp. 778 (S.D.N.Y. 1956), *aff'd*, 239 F.2d 766 (2d Cir. 1956).

[255] IRC § 1312(7)(A). This technical requirement has produced some harsh results. *See* Koss v. United States, 69 F.3d 705 (3d Cir. 1995) (holding that a lawyer's receipt of stock that produced a large deficiency in income tax in a

consisted of one of the following: (a) the erroneous inclusion in, or omission from, gross income, (b) the erroneous recognition or nonrecognition of gain or loss, (c) the erroneous deduction of an item that should have been capitalized, or (d) the erroneous capitalization of a properly deductible item;[256] and (iv) the taxpayer with respect to whom the error occurred must be one of the following: (a) the taxpayer involved in the determination, (b) a taxpayer who acquired title to the property in the erroneously treated transaction and from whom the taxpayer involved in the determination derived title in such a manner as to obtain a basis ascertained by reference to the basis of the taxpayer who acquired title in the erroneously treated transaction, or (c) a taxpayer who had title to the property at the time of the erroneously treated transaction, and who later made a gift of the property to the taxpayer involved in the determination.[257]

Some taxpayers have argued that the mitigation provisions should apply to allow the payment of income tax refunds to estates or other recipients of property acquired from a decedent who had paid taxes on gains from the sales of property based on reported estate tax values, when the IRS subsequently succeeds in claiming higher estate tax values and imposing estate tax deficiencies. If the final estate tax determination is made after the applicable statute of limitations for claiming a refund for overpayment of income taxes has expired, they have argued, the estates or recipients should be able to invoke IRC § 1312(7) and obtain relief. An estate successfully made this argument before the Fourth Circuit in *Chertkof v. United States*.[258] The

prior year was not a determination in respect of a later failure to claim a deduction for worthlessness of the same stock); O'Brien v. United States, 766 F.2d 1038 (7th Cir. 1985), *rev'g* 582 F. Supp. 203 (C.D. Ill. 1984) (holding that the donee failed to meet two requirements of IRC § 1312(7), including that the underlying error occurred "in respect of" the basis determining transaction); Gardiner v. United States, 536 F.2d 903 (10th Cir. 1976) (holding that the failure to deduct depreciation was not an erroneously treated transaction for the purpose of IRC § 1312(7)(A)); Am. Found. Co. v. Commissioner, 2 T.C. 502 (1943) (holding that the government failed to satisfy the "in respect of" test). If the Seventh Circuit's analysis in *O'Brien* correctly interprets the statute, Congress may want to consider revising IRC § 1312(7)(A) to remove the "in respect of" standard, regardless of whether it permanently repeals the estate tax.

[256] IRC § 1312(7)(C). *See* Cent. Hanover Bank & Trust Co. v. United States, 163 F.2d 60 (2d Cir. 1947); Rev. Rul. 70-7, 1970-1 C.B. 175 (finding that error was not of one of those types that IRC § 1312(7)(C) describes because the determination established the cost basis of certain lots in tract and that the basis of other lots previously disposed of had been determined erroneously).

[257] IRC § 1312(7)(B). *See also* IRC § 1311(b)(3) (providing that a correction of error may be made by or against a person related to the taxpayer, if the prescribed relationship provided for in IRC § 1313(c) exists at the time the taxpayer first maintains the inconsistent position in a tax return, claim for refund, or petition (or amended petition) to the Tax Court for the tax year with respect to which the determination is made, or if the position is not so maintained, if the prescribed relationship exists at the time of the determination).

[258] 676 F.2d 984 (4th Cir. 1982). The Fourth Circuit in *Chertkof* rejected the position contained in the regulations that mitigation does not apply to adjust a prior estate tax liability against an income tax determination. *See* Treas. Reg. § 1.1311(a)-2(b) (providing that error and determination must involve the same type of federal tax and that, moreover, mitigation rules are inapplicable to determinations under the estate tax). *Accord* Provident Nat'l Bank v. United States, 507 F. Supp. 1197 (E.D. Pa. 1981) (holding that mitigation provisions are not applicable to inconsistencies between the estate tax and the income tax); *cf.* Hall v. United States, 975 F.2d 722 (10th Cir. 1992) (2-1 decision) (holding that the mitigation provisions are inapplicable to a windfall profits tax refund claim and that both determinations must be with respect to the income tax).

The IRS generally is not estopped from taking a position for income tax purposes inconsistent with the position it has taken for estate tax purposes. Res judicata, collateral estoppel, closing agreements, or the statutory

Seventh Circuit, in *O'Brien v. United States*, however, refused to apply IRC § 1312(7) under similar operative facts.[259] It based its decision on the fact that the alleged erroneous earlier event, the decedent's death that led to the determination of basis under IRC § 1014, was not a realization event for income tax purposes.[260] IRC § 1312(7) (or other circumstance of adjustment) likely is not applicable in order to mitigate a tax other than income tax, and therefore mitigation would seem to be unavailable.[261]

e. The Doctrine of Equitable Recoupment. In addition to quasi-estoppel and the mitigation provisions, various courts have, in special or limited instances, invoked the judicially created doctrine of equitable recoupment.[262] They apply this doctrine to avoid unfair treatment of either the IRS or the taxpayer when a particular transaction involving the same party spans a period that exceeds the time allowed for imposing a deficiency or claiming a refund. It is an affirmative defense to a particular action initiated by the taxing authority (deficiency) or the taxpayer (refund), and, therefore, neither the IRS nor the taxpayer can use it affirmatively to invoke a court's jurisdiction to open a barred year.[263] This court-made doctrine allows for a claim for a deficiency in or a refund of taxes, which otherwise is barred by a statute of limitations, still to be recouped or offset against a tax claim of the taxpayer (in the case of a time-barred deficiency assessment) or of the government (in the case of a time-barred refund).[264] Equitable

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mitigation provisions, however, do place limits on its ability to take inconsistent positions. *See* Tenn. Prod. Corp. v. United States, 107 F. Supp. 578 (Ct. Cl. 1952); Boykin v. Commissioner, 16 B.T.A. 477 (1929).

[259] 766 F.2d 1038 (7th Cir. 1985) *rev'g* 582 F. Supp. 203 (C.D. Ill. 1984). The Seventh Circuit's decision in *O'Brien*, although in substance in conflict with the Fourth Circuit's decision in *Chertkof*, reconciled the two cases as not inconsistent on the basis that the government in *Chertkof* failed to raise the "in respect of the same transaction" argument that was crucial to the Seventh Circuit's finding for the government.

[260] For a recent case refusing to allow the IRS to invoke IRC § 1312(7), see Mun Li Fong v. Commissioner, T.C. Memo. 1998-181, 75 T.C.M. (CCH) 2299 (holding that a stipulated settlement did not have sufficient specificity to constitute a "determination" for purposes of IRC § 1313(a)).

[261] Although the two cases involved a taxpayer invoking relief under IRC § 1312(7), the IRS may itself want to rely on it to prevent taxpayers from exploiting the statutes of limitation. That can occur if: (i) a recipient of property acquired from a decedent later claims a higher basis for that property in a sale that occurs after the statute of limitations on the federal estate tax has expired, and (ii) that recipient is not under a duty of consistency and subject to the quasi-estoppel doctrine. Unless the IRS can invoke IRC § 1312(7), it will not be able to go back against an estate for additional estate taxes based on the later determination that the basis for income tax purposes was greater than that reported for estate tax purposes.

[262] *See* United States v. Dalm, 494 U.S. 596 (1990); Rothensies v. Elec. Storage Battery Co., 329 U.S. 296 (1946); McEachern v. Rose, 302 U.S. 56 (1937); Stone v. White, 301 U.S. 532 (1937); Bull v. United States, 295 U.S. 247 (1935); Estate of Bartels v. Commissioner, 106 T.C. 430 (1996). The doctrine predates the enactment in 1938 of the mitigation provisions. *See* Lewis v. Reynolds, 284 U.S. 281 (1932) (permitting a setoff to reduce the refund claim for unpaid taxes for the same period), *modified*, 284 U.S. 599 (1932).

[263] United States v. Dalm, 494 U.S. 596 (1990); Estate of Mueller v. Commissioner, 107 T.C. 189 (1996), *aff'd*, 153 F.3d 302 (6th Cir. 1998).

[264] *See* Arthur W. Andrews, *Modern-Day Equitable Recoupment and the 'Two Tax Effect': Avoidance of the Statutes of Limitation in Federal Tax Controversies*, 28 ARIZ. L. REV. 595, 632–34 (1986); Heather Belin, *Toward a More Equitable Tax System: A Call for Congress to Codify Equitable Recoupment*, 2001 FED. B. ASS'N SEC. TAX'N REP. 1; John A. Lynch, Jr., *Income Tax Statute of Limitations: Sixty Years of Mitigation—Enough, Already!!* 51 S.C. L. REV. 62 (1999); Camilla E. Watson, *Equitable Recoupment: Revisiting an Old and Inconsistent Remedy*, 65 FORDHAM L. REV. 691 (1996); Steven J. Willis, *Some Limits of Equitable Recoupment, Tax Mitigation, and Res Judicata: Reflections Prompted by* Chertkof v. United States, 38 TAX LAW. 625 (1985).

recoupment is available: (i) when either a taxpayer or the IRS asserts an inconsistent position, while still claiming that the statute of limitations bars correction of a prior wrong; (ii) the inconsistent position produces a double benefit for either the taxpayer or the IRS, whichever one is asserting the inconsistent position; (iii) the inconsistent claims arise out of the same transaction;[265] and (iv) the inconsistent claims involve the same taxpayer or two or more taxpayers who have a shared identity of interest.[266]

The courts have applied the doctrine to a number of situations involving the estate tax and recipients of property acquired from decedents. They have applied it to a situation in which the IRS asserted a deficiency in estate tax by increasing reported asset values after the estate had paid federal income tax based on previously reported asset values and the statute of limitations for a refund of income tax had expired.[267] Courts also have applied it to a situation in which the government claimed that the gross estate should include certain assets as corpus after the taxpayer had reported those assets as income and the statute of limitations for a refund of income taxes had expired.[268] Yet another situation to which they have applied the doctrine is when a decedent's additional liability to pay federal income taxes had not been determined until after the statute of limitations on a claim for a refund of federal estate taxes had expired.[269]

Prior to the Tax Court's reorganization in 1969 to become a legislative court under Article I of the Constitution, it did not have jurisdiction to consider the affirmative defense of equitable recoupment.[270] Even after its reorganization, the Tax Court adhered to the view that it lacked jurisdiction to apply equitable recoupment.[271] Picking up on a suggestion raised in the U.S. Supreme Court's decision in *United States v. Dalm*,[272] the Tax Court in its 1993 decision in *Estate of Mueller*[273] and in its 1996 decision in *Estate of Bartels*,[274] came to recognize its power as an Article I court to grant the remedy of equitable recoupment.[275]

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[265] *See* Ford v. United States, 276 F.2d 17, 23 (Ct. Cl. 1960). The courts have not consistently applied the "same transaction" requirement. Estate of Branson v. Commissioner, 113 T.C. 6 (1999), *aff'd*, 264 F.3d 904 (9th Cir. 2001), chronicles the history of the same transaction requirement, as well as the other elements composing the affirmative defense of equitable recoupment.

[266] *See* Boyle v. United States, 355 F.2d 233, 236 (3d Cir. 1965).

[267] *See*, *e.g.*, Estate of Branson v. Commissioner, 264 F.3d 904 (9th Cir. 2001) (holding that the Tax Court had jurisdiction to consider the defense of equitable recoupment and that it properly allowed the residuary beneficiary to apply the income tax overpayment against the estate tax deficiency).

[268] Bull v. United States, 295 U.S. 247 (1935).

[269] *See* Estate of Orenstein v. Commissioner, T.C. Memo. 2000-150, 83 T.C.M. (CCH) 1859.

[270] Commissioner v. Gooch Milling & Elevator Co., 320 U.S. 418 (1943) (holding that, as an administrative agency, the Board of Tax Appeals' jurisdiction did not extend to claims of equitable recoupment), *vacated by* 142 F.2d 452 (8th Cir. 1944); *accord* Mohawk Petroleum v. Commissioner, 148 F.2d 957 (9th Cir. 1945), *aff'g* 47 B.T.A. 952 (1942). The Tax Reform Act of 1969, Pub. L. 91-172, § 951, 83 Stat. 487, 730, made the Tax Court a legislative court under Article I of the Constitution. *See* Freytag v. Commissioner, 501 U.S. 868 (1991).

[271] *See* Estate of Schneider v. Commissioner, 93 T.C. 568 (1989); Phillips Petroleum Co. v. Commissioner, 92 T.C. 885, 889–90 (1989); Van Winkle's Estate v. Commissioner, 51 T.C. 994, 999-1001 (1969).

[272] 494 U.S. 596, 610–11(1990).

[273] 101 T.C. 551 (1993), *and* 107 T.C. 189, *aff'd*, 153 F.3d 302 (6th Cir. 1998) (for further discussion of this case, see *infra* note 275).

[274] 106 T.C. 430 (1996).

[275] The Tax Court since has confirmed its power to grant equitable recoupment as an affirmative defense in cases brought before it. Estate of Branson v. Commissioner, 113 T.C. 6 (1999), *aff'd*, 264 F.3d 904 (9th Cir. 2001); Estate

4. Compliance Issues and Taxpayer Burdens Under IRC § 1022

a. Record-Keeping Burdens. IRC § 1022 imposes substantial record-keeping burdens and requirements on taxpayers. Under IRC § 1022(a)(2)(A), estates have to identify and support with corroborating evidence the original cost of an asset plus adjustments for subsequent taxable events, such as improvements, depreciation deductions, cost recovery allowances, and exchanges.[276] An executor is likely to have the most difficulty in proving a decedent's adjusted basis in an asset for individual items of tangible personal property, such as jewelry, artwork, and other collectibles.

b. Asset Appraisals. An executor must determine the fair market value of every asset acquired from a decedent in order to comply with three aspects of the modified carryover basis rule. First, IRC § 1022(a)(2)(B) provides that the basis of property acquired from a decedent is its fair market value at the date of the decedent's death, if that value is less than the asset's adjusted basis. Second, IRC § 1022(d)(2) limits basis increases to an asset to an amount that when added to the decedent's adjusted basis does not increase the asset's basis above its fair market value. Third, IRC § 1022(b)(2)(C)(ii) defines built-in losses, which the statute allows as part of the aggregate basis increase, as the amount that IRC § 165 would have allowed as a loss if the decedent had sold the asset at its fair market value determined immediately before the decedent's death. IRC § 1022's appraisal requirements potentially could result in significant costs to an estate.

c. Pass-Through Entities. IRC § 1022 raises special problems and complexities for estates containing interests in closely held businesses, particularly interests in privately held, pass-through entities. These entities require careful monitoring of a decedent's tax basis in shares of stock in an S corporation, limited liability company, general or limited partnership, or similar pass-through entity. Even though the statute of limitations on assessment of additional income taxes against the decedent may have expired, the IRS may make further adjustments to basis for entity- or investor-level events from barred years. Therefore, the executor of the decedent's estate must be able to account for basis adjustments for all years for which the decedent held interests in pass-through entities.

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of Orenstein v. Commissioner, T.C. Memo, 79 T.C.M. (CCH) 1971. 2000-150. The Tax Court makes the critical distinction between "equitable powers," which it does not have because it derives its jurisdiction by specific statutory provision, and the power to apply equitable principles in deciding cases within its jurisdiction, such as waiver, estoppel, and reformation of written agreements.

Although the Sixth Circuit in *Estate of Mueller*, 153 F.3d 302 (1998), affirmed the Tax Court's decision that the taxpayer's claim for equitable recoupment failed, it went further and held that the Tax Court could not grant the remedy of equitable recoupment based upon *Commissioner v. Gooch Milling & Elevator Co.*, 320 U.S. 418 (1943). It failed to take into account Congress's having reconstituted the Tax Court as a judicial court. In *Branson*, the Tax Court set aside its internal *Golsen* rule of following precedent in the jurisdiction to which an appeal would be made and rejected this part of the Sixth Circuit's ruling. 113 T.C. 6 at *34 (citing Golsen v. Commissioner, 54 T.C. 742, 756–57 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), *cert. denied*, 404 U.S. 940 (1971)). *See also Orenstein*. In *Branson*, the Ninth Circuit affirmed the Tax Court's new view of its power to entertain the defense of equitable recoupment.

[276] IRC § 1015 requires the same record-keeping due diligence for transfers made by gift.

5. <u>No Repose for Modified Carryover Basis Determination</u>

a. <u>Basis Disputes in General</u>. The EGTRRA does not establish a separate statute of limitations for challenges to the reporting of basis under IRC § 6018, as amended by the EGTRRA and effective in 2010, including the allocation of the IRC § 1022(b) and (c) basis increases. Thus, even in a relatively straightforward application of IRC § 1022, for example, when recipients of assets acquired from a decedent sell those assets years after the decedent's death and the executor has allocated no basis increases to any of those assets, they have the burden of proving the correctness of the reported IRC § 1022 basis, as further adjusted for postmortem events and allowances. Recipients' ability to carry their burden of proof in establishing a basis in an asset acquired from a decedent is likely to be even more complex, both factually and legally, when the executor allocates basis increases under either IRC § 1022(b) or (c). Disputes may arise many years after a decedent's death, regarding, for example, the propriety of a claimed net operating loss or capital loss carryover, the determination of the built-in loss, or the application of the fair market value ceiling rule under IRC § 1022(d)(2). In the meantime, recipients may have transferred the assets to entities in a manner that qualifies as a carryover basis transaction, exchanged them for other assets as part of a tax-free exchange, or transferred them incident to a divorce.[277]

Presumably, the final regulations for IRC § 1022(d) will not impose an affirmative duty on the part of the IRS to challenge, within a prescribed period after an executor files an information return under IRC § 6018, basis increase amounts or their allocation to assets.[278] The mitigation provisions would not treat the filing of the information return as an erroneous determination, because the IRS would not have conducted an audit or made an assessment and the requirements under IRC § 1312(7), having to do with circumstances of adjustment of basis, would not be met.[279] The mitigation provisions in their present form would come into play only in limited instances, such as when an estate sells a divisible part of an asset and a recipient, who acquires a divisible part of the same asset from the decedent, sells it after the estate's opportunity to file a claim for refund for an overpayment of tax for the earlier sale has expired. The similar remedy of equitable recoupment may have limited application as well, because a taxpayer may invoke it only as an affirmative defense to a deficiency that the IRS asserts and, even then, only if the other requirements of this court-made remedy are met.[280] Thus, taxpayers cannot rely on information returns under provisions of IRC § 6018, but instead have the burden of proving the correctness of the modified carryover basis of an asset as determined under IRC § 1022, regardless of the number of years that may have elapsed since the date of the decedent's death.

b. <u>Basis Disputes Involving Loss Carryovers and Built-In Losses</u>. IRC § 1022(b)(2)(C) supplements the aggregate basis increase of $1.3 million by the amount of a decedent's loss

[277] For examples of carryover basis transactions involving entities, see IRC §§ 358 (having to do with corporate organizations), 722 (having to do with contributions to partnerships). For examples of tax-free exchanges, see IRC §§ 368 (having to do with corporate reorganizations), 1031 (having to do with like-kind exchanges). For the carryover basis rules for transfers incident to a divorce, see IRC § 1041.
[278] For further discussion of a duty to audit the information return, see *supra* § 13.1.
[279] For further discussion of the mitigation provisions and IRC § 1312(7), see *supra* § 13.3.
[280] For further discussion of the doctrine of equitable recoupment and its requirements, see *supra* § 13.3.

carryovers and built-in losses. The modifications to basis for loss carryovers and built-in losses further complicate the determination of the amount of the aggregate basis increase, as well as the executor's allocation of it. Neither the statute nor the legislative history describes how the executor is to make the loss carryover and built-in loss modifications or how the executor is to allocate these basis adjustments to the various assets.[281] IRC § 1022 appears to impose no restrictions on how the executor allocates the amount of aggregate basis increase determined under IRC § 1022(b), except to indicate, under IRC § 1022(d)(2), that the basis increase when added to the decedent's adjusted basis cannot exceed the asset's fair market value determined at the date of the decedent's death.

In addition, if the IRS were to challenge the amount of the aggregate basis increase based on loss carryovers or built-in losses upon a subsequent disposition by a recipient of an asset acquired from a decedent, the statute does not indicate the implications of such a challenge. It is unclear whether the IRS reduces, on a dollar-for-dollar basis, the amount of the aggregate basis increase under IRC § 1022(b), which the executor allocated to the recipient's asset, or whether the IRS reduces it only on a proportional basis, taking into account the total amount of the aggregate basis increase that the executor allocated to other assets. It is anticipated that Treasury would, through regulations, adopt a proportionate rule upon its successful challenge of the amount of the aggregate basis increase.

The following example demonstrates the complex factual, valuation, and analytical questions that can arise regarding the modifications of basis that IRC § 1022(b) permits.

> *Example 1: Dispute concerning the amount of a decedent's loss carryover*. *G* dies in 2010 owning three parcels of unimproved land.[282] *Whiteacre* has a cost basis at death of $500,000 and a fair market value of $2 million. *Blackacre* has a cost basis at death of $1 million and a fair market value of $3 million. *Greenacre* has a cost basis at death of $200,000 and a fair market value of $500,000. *G* bequeaths *Whiteacre* to *S*, his son, *Blackacre* to *D*, his daughter, and *Greenacre* to *N*, his favorite nephew. At *G*'s death, he had an unused net operating loss of $1.7 million from a failed restaurant business in which neither *S* nor *D* had any involvement. *G*'s executor, which is the *XYZ Bank*, determines that the aggregate basis increase under IRC § 1022(b) is $3 million, comprised of the $1.3 million standard amount allowed under IRC § 1022(b)(2)(B) plus the $1.7 million in net operating loss allowed under IRC § 1022(b)(2)(C)(i). *XYZ Bank* allocates one-half of the aggregate basis increase to *S* and one-half of it to *D*. The executor does not allocate any part of the aggregate basis increase to *N*. The bases of the three parcels of land under IRC § 1022 are:

[281] For an illustration of a comprehensive allocation system, see IRC § 1060 (having to do with acquisitions of trade or business assets).
[282] The example uses unimproved land to avoid addressing complex issues relating to interim basis adjustments for depreciation and cost recovery allowances.

Whiteacre:	$2 million [283]
Blackacre:	$2.5 million[284]
Greenacre:	$200,000[285]

IRC § 1022(d)(3)(B) suggests that *XYZ Bank*'s allocation of the aggregate basis increase amount is binding on both *XYZ Bank* and the IRS, unless *XYZ Bank* changes the allocation in accordance with rules that Treasury has established. The statute, however, does not bind the IRS by the amount of the aggregate basis increase, which *XYZ Bank* reports on the information return required under IRC § 6018, amended by the EGTRRA and effective in 2010.

In 2016**,** *S* gives *Whiteacre* to his son, *GS*, at which time the fair market value of *Whiteacre* is $3 million.[286] *GS* sells *Whiteacre* in 2020 for $4 million and reports a gain of $2 million. In 2022, the IRS issues a notice of deficiency to *GS* by increasing the amount of *GS'*s gain by $700,000, claiming that the net operating loss available to the estate through *G* was only $1 million and not $1.7 million.[287]

One question that arises is whether the IRS should charge *GS* with the entire downward adjustment in the alleged correct amount of the net operating loss or, instead, should charge him only with one-half of it, or $350,000, based on the proportion of the net operating loss that *XYZ Bank* had allocated to *Whiteacre*. A further question is whether the issue of the amount of the net operating loss collaterally estops *D* from claiming that the amount of the net operating loss that *XYZ Bank* originally reported is correct.[288] Neither the statute nor legislative history provides an answer to this question.

Three years later, in 2025, *D* sells *Blackacre* for $4,000,000. She claims, however, that the estate had been wrong in stating that the net operating loss was $1.7 million, as *XYZ Bank* reported on the information return, and that the IRS also was incorrect in determining that the prior net operating loss was only $1 million. Instead, she claims that the net operating loss was $2.5 million and, therefore, claims an income tax basis of $2.9 million.[289] *D* was not the executor of the estate and, therefore, she is not subject to the duty of consistency doctrine.[290] Moreover, although IRC § 1022(d)(3)(B) arguably binds recipients of property acquired from a decedent to the allocation of

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[283] The $2 million consists of the decedent's adjusted basis of $500,000 plus $1.5 million, which is one-half of the IRC § 1022(b)'s aggregate basis increase of $3 million ($1.3 million (IRC § 1022(b)(2)(B)) and $1.7 million (IRC § 1022(b)(2)(C)(i))).

[284] The $2.5 million consists of the decedent's adjusted basis of $1 million plus $1.5 million, which is one-half of the IRC § 1022(b)'s aggregate basis increase of $3 million ($1.3 million (IRC § 1022(b)(2)(B)) and $1.7 million (IRC § 1022(b)(2)(C)(i))).

[285] The $200,000 consists only of the decedent's adjusted basis. *XYZ Bank* allocated no further basis increases to *Greenacre*.

[286] For simplicity purposes, the example ignores the adjustment to basis for the amount of gift tax paid on the difference between *Whiteacre*'s fair market value at the time of the gift and *S*'s basis in *Whiteacre* of $2 million. *See* IRC § 1015(d)(6).

[287] Generally, the courts may examine an earlier year to determine the actual amount of the net operating loss sustained in that year, even though that year is not directly involved in the litigation, and even though the statute of limitations bars the IRS from claiming a tax deficiency for that year. *See, e.g.*, Forres v. Commissioner, 25 B.T.A. 154 (1932); Hajos v. Commissioner, T.C. Memo 1964-328, 23 T.C.M. (CCH) 2015.

[288] The relative values of the assets acquired from *G* at the date of his death arguably should not matter. Only the relative amounts of the aggregate basis increase that *XYZ Bank* allocated to the assets should be relevant.

[289] The $2.9 million consists of the decedent's adjusted basis of $1 million plus $1.9 million, which is one-half of the IRC § 1022(b)'s aggregate basis increase of $3.8 million ($1.3 million (IRC § 1022(b)(2)(B)) and $2.5 million (IRC § 1022(b)(2)(C)(i))).

[290] It further would appear that the IRS could not invoke either the mitigation provisions or the equitable recoupment doctrine against *D*. For a discussion of the duty of consistency doctrine, the mitigation provisions, and the equitable recoupment doctrine, see *supra* § 13.3.

the basis increases, it does not bind them to the amount of the basis increases for loss carryovers or built-in losses under IRC § 1022(b)(2)(C). If *D* prevails in establishing that the net operating loss amount of $2.5 million is correct and *D* has a right only to one-half of that, based on *XYZ Bank*'s original allocation, a further question arises as to whether *GS* has the right to file a claim for refund, even though the statute of limitations for the year 2022 may have expired. *GS* may be able to base his refund claim on IRC § 1312(7).[291]

Example 2: Dispute concerning an asset's fair market value at the date of the decedent's death. The facts are the same as under example 1, except that the IRS does not challenge the amount of the net operating loss when *GS* sells *Whiteacre* in 2020 but, instead, in 2022 challenges *GS*'s basis for determining gain by arguing that the fair market value of *Whiteacre* in 2010 was only $1 million and not $2 million as indicated on the IRC § 6018 information return, which *XYZ Bank* filed. The IRS, therefore, claims a tax deficiency based on a gain from the sale of $3 million ($4 million amount received – $1 million basis). Under IRC § 1022(d)(2), the basis in *Whiteacre* cannot exceed $1 million, which means that *XYZ Bank* can allocate only up to $500,000 of aggregate basis increase to *Whiteacre*. If the IRS prevails, the further question arises as to what happens to the basis increase amount of $1 million ($1.5 million originally allocated reduced by the $500,000 ultimately allowed) that the IRS denies *GS*. If it is available to increase the basis of other assets acquired from the decedent, the yet further question is how that allocation can be accomplished. If both *Whiteacre* and *Blackacre* were, in the aggregate, overvalued so that the full amount of the $3 million aggregate basis increase available becomes unusable for the two parcels of land, another question arises as to whether *N* could take advantage of the unused aggregate basis increase, even though *XYZ Bank* did not originally allocate any aggregate basis increase to *Greenacre*.

The issues raised by example 2 demonstrate the risks to an executor of making allocations to assets that the IRS later determines the executor overvalued. Moreover, there is a risk in certain instances that overvaluations will not only result in lost exemption amounts but in compliance penalties.[292] The two examples demonstrate that the potential exists for an unlimited number of questions that require answers. They also demonstrate the potential for substantial compliance costs, accompanied by fiduciary burdens and uncertainties. Finally, the examples demonstrate the complexities of the disputes that can arise, many of which will not become apparent until years after the decedent's death. Moreover, resolution of the disputes requires a detailed evaluation of financial and accounting information potentially spanning multiple generations of family members. Recipients of property acquired from a decedent may have limited, if any, information from which to piece together a response to a statutory notice from the IRS challenging one or more aspects of an asset's modified carryover basis, making it difficult for them to meet their burden of proof.

Alternatives

1. <u>Repeal the Two Types of Lower of Basis or Fair Market Value Rules Found in IRC §§ 1022(a) and 1015(a)</u>. 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

[291] The computation of the net operating loss directly affects the calculation of basis under IRC § 1022, and, therefore, *GS* can argue that mitigation under IRC § 1312(7) should be available. Nevertheless, the IRS can argue that it has not maintained an inconsistent position.
[292] For a discussion of penalties, see *supra* § 13.

value of an asset. The advantage of this statutory change is that the executor would not have to obtain appraisals for built-in loss assets. Instead, the executor's entire focus would be on establishing the decedent's cost basis in each asset, as adjusted, which in some instances itself may be a formidable task. An additional advantage of this change is that it reduces the areas of dispute regarding the amount of aggregate basis increase under IRC § 1022(b), because it eliminates the need for an adjustment for built-in losses under IRC § 1022(b)(2)(C)(ii). Built-in losses would remain with the assets that generate them. The elimination of the lower of basis or fair market value rule has the further advantage of removing the potential for characterization shifting in which an executor allocates a built-in loss, which when the decedent owned the asset would have generated a capital loss, to one or more assets that generate ordinary income in the hands of the recipients. 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.[293]

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.[294] The advantage of this limitation is that it involves only a single taxpayer and promotes finality by resolving all the issues pertaining to the determination of basis under IRC § 1022 during the period of estate administration, rather than an indeterminate number of years later. 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).[295] Further, Congress could

[293] For further discussion of the treatment of assets with unrealized losses under IRC §§ 1015 and 1022, see *supra* § 7. Congress could make corresponding adjustments to other provisions, including IRC § 643(e)(1), having to do with the basis in property that a trust or estate distributes to a beneficiary.

[294] *See* IRC § 645, which treats qualified revocable trusts as part of the decedent's estate for federal income tax purposes.

[295] Special rules apply in determining whether an in-kind distribution of property from an estate results in recognition treatment. Generally, an in-kind distribution will not result in gain or loss to the estate or trust, and the beneficiary will take the estate's or trust's basis in the property. *See* IRC §§ 643(e)(4), 663(a)(1). In such a case, the amount of the distribution for purposes of both the deduction by the estate or trust and the inclusion by the beneficiary is the lesser of the estate's or trust's basis in the property or the property's fair market value. However, under IRC § 643(e), the fiduciary of an estate or trust may make an election to treat a discretionary distribution of property, or so-called tier 2 distribution, as a realization event. In a tier 2 distribution, IRC § 643(e)(1) treats the estate or trust as having sold the property to the beneficiary for its fair market value, and the beneficiary takes a fair market value basis in the property. *But see* IRC § 267 (disallowing a loss for sales between related parties).

In addition to the foregoing rules, if the fiduciary distributes property in satisfaction of a pecuniary amount provided for in a governing instrument, the distribution constitutes a sale of property for its fair market value. The distributee of a pecuniary gift or bequest acquires a basis equal to the property's fair market value. IRC § 1040, amended by the EGTRRA and effective in 2010, recognizes a gain on a transfer of property in satisfaction of a pecuniary bequest only to the extent that the fair market value of the property at the time of the transfer exceeds its fair market value at the decedent's death. In other words, IRC § 1040 does not require the estate to recognize gain based on an asset's modified carryover basis determined under IRC § 1022. IRC § 1040(c) further provides that the 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. This relief provision would prevent a gain to the extent that the asset's fair market value exceeds its modified carryover basis. The advantage of Congress's requiring IRC § 643(e) treatment is that a distribution of property to a beneficiary would be a taxable event, and the statute of limitations would start running regarding the components of the asset's basis determined under IRC § 1022(b), including loss carryovers, built-in losses, and valuation issues. The application of IRC § 643(e) for a distribution of an asset receiving an IRC § 1022(b) aggregate basis increase allocation presumably would be included in the mitigation provisions and specifically in IRC § 1312(7), having to do with circumstances of adjustment to basis, if the IRS were later to take a position inconsistent with the asset's reported basis.[296]

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.[297] The procedural problems generated by application of the modified carryover basis rule under IRC § 1022 are attributable directly to the lack of a specific statute of limitations for finalizing the allocation of IRC § 1022(b)'s aggregate basis increase. The well-recognized doctrines of quasi-estoppel, mitigation, election, and equitable recoupment are inefficient, and frequently ineffective, for resolving disputes, because they are not necessarily timely and they impose additional procedural and technical burdens on taxpayers and the IRS. The advantage of a timely audit or declaratory action is that it would produce finality with regard to each component of the modified carryover basis under IRC § 1022 for each asset acquired from a decedent, including the amount of loss carryovers, built-in losses, and fair market value at the time of the decedent's death. It also would eliminate a number of issues regarding reallocation of the aggregate basis increase and the aggregate spousal property basis increase that may arise if the IRS successfully challenges either the amount of basis increase under IRC § 1022(b)(2)(C), having to do with loss carryovers and built-in losses, or the fair market value of any asset.

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recipient of the property transferred in satisfaction of a pecuniary bequest takes a basis equal to that property's basis in the estate immediately prior to the transfer, increased by the amount of gain the estate recognized as a result of the transfer. Without this special relief provision, funding certain pecuniary bequests, including certain formula marital bequests, would result in a harsh income tax impact on an estate and its beneficiaries. *See* Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940); Treas. Reg. § 1.661(a)-2(f)(1); Rev. Rul. 74-178, 1974-1 C.B. 196 (pertaining to a distribution in satisfaction of a debt); Rev. Rul. 60-87, 1960-1 C.B. 286 (pertaining to the funding of a pecuniary marital deduction bequest).

[296] IRC § 1022(c)'s aggregate spousal property basis increase would not be affected under the estate utilization rule that the text describes.

[297] *See*, *e.g.*, IRC §§ 7428 (providing declaratory relief as to tax-exempt status), 7436 (permitting a proceeding in Tax Court for determination of employment status), 7476 (providing declaratory relief as to qualification of certain retirement plans), 7477 (providing declaratory relief for determination of the value of a gift shown on a gift tax return), 7478 (providing for a declaratory judgment relating to the status of certain governmental obligations), 7479 (providing for a declaratory judgment with respect to eligibility under IRC § 6161). Congress could require that the estate exhaust its administrative remedies before invoking a declaratory action.

§ 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.

Current Law. IRC § 1022 does not address issues pertaining to postmortem characterization of a gain or a loss. The absence of any restrictions on allocating the aggregate basis increase and aggregate spousal property basis increase gives executors unfettered authority, subject to state law constraints, to shift the incidence of future taxation between high-bracket recipients of a decedent's property, including an estate, and low-bracket recipients. In addition, executors may take into account any special tax history of the recipients, such as their having carryover capital losses. Further, executors have complete discretion as they allocate basis increases.[298] Obviously, the basis adjustments have greater value for assets that would be taxed at ordinary rates when sold.

In contrast, IRC § 1014's step-up in basis rule is asset specific, and no one has the discretion to shift basis increases representing unrealized appreciation among a decedent's assets.[299] Although IRC § 1014 generally ignores previous depreciation deductions when increasing the basis of an asset to its fair market value at the decedent's death, it does not allow anyone to convert ordinary income into capital gain.[300] Notwithstanding the apparent differences between IRC §§ 1014 and 1022 with respect to recharacterization issues, neither the statute nor its legislative history indicates that executors are prohibited from recharacterizing income and losses. Executors' ability to do so would represent a dramatic shift in tax policy.

The problems of recharacterization are particularly acute with regard to the basis adjustments allowed under IRC § 1022(b)(2)(C). The tax law consistently has recognized the fundamental differences between net operating losses and capital losses. IRC § 1022(b)(2)(C), however, treats them as interchangeable for the purpose of determining the amount of basis increase available to add to any asset acquired from the decedent. Furthermore, the built-in loss

[298] This flexibility undoubtedly is helpful in reducing the impact of federal (and state) income taxes for assets that need to be sold during the period of administration in order for an estate to meet its obligations to pay any debts of the decedent and administration costs.
[299] *But see* IRC § 754, which indirectly permits a basis shift in a deceased partner's share of partnership assets.
[300] A decedent's successor in interest, however, may hold property acquired from the decedent for a different purpose than the decedent had in holding the property. IRC § 1014(b)(9) and (10) do take previous depreciation deductions into account when recipients of property acquired from a decedent have received that property before the decedent's death and have taken depreciation deductions between the time they received the property and the time of the decedent's death.

A difference between allowing a successor in interest to enjoy a second round of cost recovery allowances or amortization deductions as a result of a basis increase under IRC § 1014 and as a result of a basis increase under IRC § 1022 is that an estate tax is applied to the property enjoying the basis increase under IRC § 1014. That difference may not be very persuasive because the step-up in basis is available even if the property did not incur estate taxes because of the marital deduction or applicable unified credit exclusion amount. Arguably, IRC § 1022 is correct in its permitting a second round of depreciation or amortization deductions, notwithstanding the absence of an estate tax, because the decedent and the recipient of property acquired from the decedent are two distinct taxpayers and distinguishing their tax histories is appropriate.

rule of IRC § 1022(c)(2)(C)(ii) allows an estate to increase the basis of other assets, including an asset that has a basis that the decedent had reduced previously in accordance with cost recovery or other similar allowances, regardless of the character that loss would have had if the decedent had sold it immediately before death.[301] Indeed, the built-in loss rule, by design, sanctions an estate's ability to shift basis among various assets regardless of character. Thus, an executor can allocate built-in losses from stocks and securities, including losses attributable to worthlessness in accordance with IRC § 165(g), to income-producing assets that do not enjoy preferential rate treatment in the event of a sale or disposition. Although IRC § 1211(b) limits taxpayers' use of capital losses during their lifetimes, IRC 1022(b)(2)(C)(ii) effectively removes those restrictions at their deaths.[302]

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. The advantage of a dual basis rule is that basis increases reflecting unrealized capital gains would not be available to offset ordinary income through cost recovery or amortization allowances. The rule also prevents double recovery of the same costs, once by the decedent and once again by the recipient. The disadvantage of the dual basis rule is that it adds further complexity to the tax system.

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. The advantage of this approach is that it accomplishes Congress's goal of providing the

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[301] *Cf.* IRC § 1014(b)(9), (10) (having to do with the law denying a step-up in basis to assets held by a taxpayer to the extent that the taxpayer previously had taken cost recovery deductions on the assets).

[302] Generally, an individual may deduct only capital losses against capital gains plus $3,000. Any excess may be carried forward (but not backward) indefinitely. For noncorporate taxpayers, net capital loss carryovers retain their original short- or long-term character. IRC § 1212(b)(1) treats an excess of "net short-term capital loss" over "net long-term capital gain" for the loss year as a short-term capital loss "in the succeeding taxable year," and an excess of "net long-term capital loss" over "net short-term capital gain" for the loss year as a long-term loss "in the succeeding taxable year."

decedent's successors in interest a limited amount of exemption from income, but it does so in a manner that reduces the recharacterization issues that arise under IRC § 1022. The disadvantage of a credit that an executor has discretion to allocate is that it operates without regard to whether or when a recipient had realized income or gain on property acquired from the decedent.

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. Whether Congress decides to look at the decedent's tax history regarding an asset or at the recipient's tax history regarding that asset, it would be limiting the discretion of executors to recharacterize losses.[303]

§ 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.

Current Law. The preceding discussion of the modified carryover basis rules identifies a number of compliance and fairness issues, some of which Congress could address by statutory amendment and some of which Treasury could address by regulation. Two aspects of IRC § 1022 are the source of most of the problems. The first has to do with the provision that an asset's carryover basis can never exceed that asset's fair market value, determined at the decedent's death.[304] The second has to do with the modifications to the decedent's carryover basis.[305] Of particular concern is IRC § 1022(b)(2)(C), reflecting Congress's intent to transfer a decedent's tax attributes, such as loss carryovers and built-in losses, to recipients of the decedent's property.[306] The merger of otherwise expiring income tax attributes with carryover basis injects many new complexities into the income tax law. The executor's unlimited authority to allocate the basis increases of IRC § 1022(b) and (c) adds to the uncertainties and complexities produced by IRC § 1022.[307] Moreover, the lack of symmetry between lifetime and deathtime transfers places substantial burdens on both taxpayers and the IRS.[308]

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

[303] If Congress were to adopt this type of approach, presumably it also would apply it to the character of suspended losses from flow-through entities. For a discussion of other alternatives related to flow-through entities that are pertinent to this approach, see *supra* § 10.
[304] For a discussion of the fair market value limitation, see *supra* § 7.
[305] For a discussion of basis increases, see *supra* §§ 7 and 10.
[306] For a discussion of loss carryovers and built-in losses, see *supra* § 10.
[307] For a discussion of the allocation provision, see *supra* § 12.
[308] For a comparison of lifetime and deathtime transfers, see *supra* § 7.2.d.

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. Elimination of the decedent's tax attributes from the determination of the aggregate basis increase removes the opportunities for manipulation of tax rules, including the potential to recharacterize income and losses, and a significant source of disputes that could remain unresolved for many years after the decedent's death.

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. The advantage of this approach is that it simplifies the carryover basis rule while achieving Congress's intent of preventing income taxation, which would result from a carryover basis rule, of those recipients of property acquired from a decedent who would not have incurred either estate or income tax liabilities under the estate tax/step-up in basis rules. It eliminates disputes about the fair market value of an asset and the amount of loss carryovers. The disadvantage of this approach is that the income exemption is wholly unrelated to the amount of unrealized appreciation attributable to the property that a decedent's beneficiary in fact receives. In that regard, it raises questions of fairness among beneficiaries. It also raises questions about why the mere fact that a taxpayer is a beneficiary of a decedent's estate makes that taxpayer more deserving of an income exemption than other taxpayers.

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. The advantage of Congress's eliminating these adjustments to basis is that it significantly would reduce compliance issues attributable to the determination of fair market value and procedural questions pertaining to the determination of basis many years after a decedent's death.

A strict carryover basis rule, analogous to IRC § 1041, having to do with interspousal transfers, retains the decedent's built-in losses. It eliminates, however, the compliance and administrative costs of obtaining appraisals of the built-in loss assets and the assets to which the executor allocates the built-in losses. It also prevents recharacterization of gains or losses.

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). The advantage of not having the loss carryovers become a part of an asset's basis is that it avoids recharacterization issues and complex adjustments to basis. Moreover, it would eliminate the indefinite use of net operating losses.

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. The advantage of this approach is that it would provide finality to disputes regarding fair market values and loss carryovers. It also has the advantage of preventing assignment of income. The disadvantage is that it could lead to substantial income tax liability at death and possibly liquidity crises. Appendix A contains a further discussion of a deemed-realization system and compares it to other alternative tax systems.

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.

Current Law. IRC § 2503(b) permits each taxpayer to transfer assets with a value up to $11,000 (indexed) to each donee each year without incurring any gift tax and without utilizing any of the taxpayer's unified credit. Congress enacted the gift tax annual exclusion so that taxpayers could avoid having to keep records for numerous small gifts.[309]

IRC § 2503 limits the annual exclusion from the gift tax to gifts of "present interests" in property. Treas. Reg. § 25.2503-3(b) defines a present interest to be "[a]n unrestricted right to the immediate use, possession, or enjoyment of property or the income from property . . . ." Although the purpose underlying the present interest requirement is not clear, the present interest requirement does make it easier to identify donees in certain circumstances.

There are other issues concerning gifts made in trust related to the present interest requirement. Two types of trust interests can qualify for the annual exclusion: (i) the annual payment of income from a trust for a term of years or a person's life and (ii) a withdrawal power.[310] Under *Crummey v. Commissioner* and other later cases, a withdrawal power that a donee may exercise, even if only for a limited period of time, qualifies as a present interest.[311] Donors use *Crummey* powers extensively when they want to have the income and corpus remain in trust, rather than distributed to the beneficiaries named in the trust. Donors also use limited *Crummey* withdrawal powers as part of an option to fund premium payments on life insurance policies that a trust owns. A transfer of funds to a life insurance trust ordinarily does not qualify as a gift of a present interest and, therefore, does not qualify for the annual exclusion, except for the withdrawal power.[312] Technical aspects of *Crummey* powers make reliance on professional advice a near requisite.[313] Other added complexities pertaining to *Crummey* powers concern the application of the "five or five" power rules under IRC §§ 2041(b)(2) and 2514(e), which make an exception to the rule that the release of a general power is a transfer for purposes of estate and

[309] H.R. Rep. No. 72-708, at 29 (1932); S. Rep. No. 72-665, at 41 (1932).
[310] IRC § 2503(c) makes an exception to the present interest requirement for gifts made in trust for minors. The donor can make a gift in trust, giving a trustee the discretion to distribute or accumulate the income from the property as long as the trustee distributes the property and any accumulated income when the minor attains 21. If the minor dies before attaining 21, IRC § 2503(c)(2)(B) requires the trust to provide that the trustee pay the property and any accumulated income to the minor's estate or as the minor directs under a general power of appointment.
[311] Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968); Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991), *acq. in result*.
[312] Treas. Reg. § 25.2503-3(c) (Ex. 2).
[313] Rev. Rul. 81-7, 1981-1 C.B. 474, which held that a *Crummey* power is illusory if the power holder has neither knowledge of nor a reasonable opportunity to exercise that power.

gift taxes. IRC §§ 2041(b)(2) and 2514(e) provide that a lapse of a general power of appointment with respect to an amount that does not exceed the greater of $5,000 or 5 percent of the aggregate value of the property subject to the power at the time of the lapse shall not be considered a release and, therefore, shall not be subject to the estate and gift tax rules pertaining to powers of appointment. To the extent the *Crummey* power exceeds $5,000 or 5 percent of the property subject to the power, the lapse of the power leads to estate and gift tax consequences for the donee. Additional income tax complications arise because IRC § 678 treats a donee with a withdrawal power over a portion of a trust as the owner of that portion of the trust for income tax purposes.

The gift tax annual exclusion plays a related role under the GST tax law that adds to the complexities of its operation. Outright gifts to grandchildren and other generation-skipping transfers that qualify for the gift tax annual exclusion are not subject to the GST tax. Donors cannot enjoy the GST tax exclusion for gifts made in trust, however, unless the transfers meet the requirements of IRC § 2642(c). IRC § 2642(c) assures that the donees receive an interest that will be subject to estate and gift taxes, if the donees were to transfer the gift at death or during life.[314] The exclusion for gifts made in trust under the GST tax is more restrictive than the exclusion under the gift tax. These different requirements create confusion for taxpayers and financial advisers, because a transfer that qualifies for the gift tax annual exclusion can result in a taxable transfer under the GST tax.[315]

If the purpose of the present interest requirement merely is to identify the donee, the *Crummey* power serves that purpose. If that is its only purpose, however, requirements for assuring some opportunity for the donee to exercise the power seem unnecessary. If Congress intends the present interest requirement to assure the donee immediate ownership rights, with corresponding wealth transfer tax consequences, a withdrawal power exercisable for a limited period of time created by well-advised donors may undermine that goal.

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. The first group of alternatives addresses revisions to the present interest requirement. The second alternative deals with the elimination of the present interest requirement. Alternative 3 deals with

[314] IRC § 2642(c)(2) states that:

> any transfer to a trust for the benefit of an individual [will not qualify as an exclusion from the direct skip rules] unless:
>
> (A) during the life of such individual, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such individual, and
>
> (B) if the trust does not terminate before the individual dies, the assets of such trust will be includable in the gross estate of such individual.

[315] For further discussion of the annual exclusion and the GST tax, see *infra* § 27.B.

the dollar limitations on the annual exclusion, and alternative 4 proposes an expansion of the annual exclusion.

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.[316] This alternative would disallow the gift tax annual exclusion for a transfer of property into a trust that qualifies because of a *Crummey* power, but it also would disqualify other types of gifts made in trust. 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). On the other hand, if Congress wants to continue to allow the annual exclusion for some gifts made in trust, it may want to consider the next alternative.

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. This alternative would disallow the gift tax annual exclusion for transfers of property into a trust that now qualify only because they are subject to a *Crummey* power.

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 *Crummey* power does not satisfy the present interest requirement. This alternative would eliminate the compliance complexities of withdrawal powers, but would not eliminate the discrepancies between the gift and GST tax rules regarding the annual exclusion.

d. Retain the Present Interest Requirement and Establish Rules for a Qualifying Withdrawal Power. Congress could retain the present interest requirement and codify *Crummey* powers. By establishing what constitutes a qualifying withdrawal power, Congress would eliminate the uncertainties and complexities that arise because taxpayers have to rely on a smattering of cases, revenue rulings, technical advice memoranda, and private letter rulings. If Congress were to codify *Crummey* powers, 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

[316] *See supra* note 310.

the annual exclusion. If the rationale for the present interest requirement is that the requirement helps to identify the beneficiary, it is not clear why gifts of present interests satisfy that objective, while gifts of future interests do not. Elimination of the present interest requirement would remove many of the annual exclusion's existing technical complexities and compliance costs. 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.[317]

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. (This alternative would penalize those donors with large families.) 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. (This alternative also penalizes those donors with large families.) 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. This rule would permit one donee to receive the entire amount allowed or a number of donees to receive gifts up to the aggregate amount allowed. Under this approach, it would not matter who received the property or what type of interest that person received, which would mean that Congress could eliminate the present interest requirement. (This alternative may make it difficult for donors to make gifts to numerous donees and may penalize large families.)

Any limitation on the annual exclusion is problematic to the extent that it requires taxpayers to keep records of the small gifts that Congress has intended the annual exclusion to ameliorate. For that reason, an approach that imposes an annual cap on the number of gifts or on the aggregate annual amount of exempt transfers may prove to be unenforceable. With any of these limitation rules or with the current limitation of $11,000 to each donee each year, therefore, Congress may want to provide for a *de minimis* annual per donee rule for outright transfers to accommodate modest gifts to friends and family members that are not part of estate planning considerations. A problem with this alternative is that it creates an annual exclusion for the annual exclusion.

4. Expand the Availability of IRC § 2503(e). Family behavior and obligations have changed significantly since the enactment of the annual exclusion. Many individuals now support elderly parents in assisted living or nursing homes. Under the laws of most states, a child does not have the legal obligation to support a parent, which means that these payments are gifts. In many instances, the expenses paid by a child to support a parent exceed the gift tax annual exclusion amount. Because a payment by a child to support a parent does not have any estate tax benefit, Congress may want to expand the medical exclusion rule found in IRC § 2503(e) by

[317] For further discussion of valuation issues, see *infra* § 18.B.

allowing an exclusion for the payment of medical expenditures that qualify for deduction under IRC § 213.

Another instance of how family behavior and obligations have changed since the enactment of the annual exclusion is parents who incur the increased costs (other than tuition) of supporting children pursuing higher education for a longer period of time than they generally did in the past. Under the laws of some states, a parent does not have the obligation to pay the room and board of a child over the age of majority pursuing higher education, which means that these payments are gifts. The education expenses paid by a parent frequently can exceed the gift tax annual exclusion amount. Congress 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. To limit the possible abuse of this expansion, payments of such expenses could be limited to those individuals who are considered dependents under IRC § 152.

§ 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.

Current Law. IRC §§ 2010 and 2505 provide each taxpayer with a unified credit, which permits the taxpayer to transfer the unified credit applicable exclusion amount without incurring gift tax during life or estate tax at death. Similarly, IRC § 2631 provides each taxpayer with a GST exemption, which the taxpayer can allocate under IRC § 2632 to avoid incurring GST tax.[318] The EGTRRA increases the scheduled estate and gift tax applicable exclusion amounts and the scheduled GST exemption amount.[319] Appendix B shows these scheduled increases.

Generally, taxpayers may use their applicable exclusion amounts and GST exemptions only for transfers that they make during life or at death. A taxpayer's spouse also may use them for lifetime transfers, if the couple elects to treat their gifts during a calendar year as made one-half by each spouse in accordance with IRC § 2513. In addition, for GST tax purposes, IRC § 2652(a)(3) allows allocation of one spouse's GST exemption to a QTIP trust for the benefit of the other spouse.

The wealth transfer tax law encourages the proliferation of "credit shelter trusts," "reverse QTIP elections," and similar devices that have little intrinsic utility, but they are necessary to preserve the use of both spouses' estate and gift tax applicable exclusion amounts and GST exemptions. Estate plans that employ these techniques often fail unless each spouse has sufficient property in his or her own name to absorb the applicable exclusion amount and the GST exemption. Thus, the law rewards both sophisticated planning and constant reallocation of wealth, but does not offer the same benefits to couples who do not engage in sophisticated planning or whose assets do not lend themselves to appropriate allocation, such as property held

[318] For further discussion of the GST exemption and allocation rules, see *supra* § 4.B and *infra* § 27.C.

[319] The amount of taxable gifts a decedent has made during life reduces the scheduled credit, and, in turn, the scheduled applicable exclusion amount, available at death.

in a qualified retirement plan. The scheduled increases in the applicable exclusion amounts and the GST exemption amount that the EGTRRA enacted aggravate this disparity and chore.

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.[320]

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. In many instances, this will reduce the use of credit shelter trusts in the estate of the first spouse to die.[321] The occasional suggestion to change the unified credit to a unified exemption would not affect this recommendation.[322] An exemption would operate to reduce the value of the surviving spouse's estate and to reduce the amount of property taxed at the surviving spouse's highest marginal estate tax rate. Whether Congress chooses to use a unified credit or an exemption, it can simulate a credit shelter plan by its allowing portability.

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. The extension of the use of the additional applicable exclusion amount to lifetime transfers allows spouses to achieve the same results that they could have achieved by strategic action.[323] The first spouse to die, in fact, could have arranged to give the surviving spouse the right to make nontaxable transfers from a credit shelter trust during the surviving spouse's life by, for example, allowing the surviving spouse to exercise a nongeneral lifetime power to appoint property from the trust.[324]

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. If not, the second surviving spouse possibly could have available three applicable exclusion amounts. The issue of multiple portable applicable exclusion amounts also arises if the surviving spouse's new spouse dies first. The advantage of limiting the number of portable applicable exclusion amounts is that it reduces record-keeping

[320] For further discussion of the planning complexities during the phaseout period, see *supra* § 2.
[321] There may be other reasons why the first spouse to die will continue to use credit shelter trusts.
[322] *See, e.g.*, Death Tax Elimination Act, H.R. 8, 107th Cong. (2001) (passed by the House of Representatives on Apr. 4, 2001).
[323] Unlike death, the timing of divorce is within a couple's control and subject to timely planning. If practicable, the couple can preserve the benefits of each spouse's applicable exclusion amounts by electing to split their gifts prior to divorce, by creating lifetime QTIP trusts, or by agreeing to a property division incident to the divorce that takes the applicable exclusion amounts into consideration.
[324] In substance, this alternative allows a limited form of "gift splitting" following the death of the first spouse. Congress may want to consider terminating this privilege if the surviving spouse remarries.

burdens. The argument for the limitation may be even stronger for a situation in which the decedent survives the death of more than one spouse. The accumulation of exclusions would flow from the discretionary act of marriage, and, accordingly, the surviving spouse, in anticipation of remarriage, would have the opportunity to do some planning in the event the loss of the portable applicable exclusion amount may affect significantly that spouse's transfer tax liability. For example, it may be feasible for the surviving spouse to use a predeceased spouse's portable applicable exclusion amount for lifetime gifts before remarriage. Therefore, Congress may decide that any hardship arising upon remarriage is outweighed by the benefits of a simplified proposal that precludes the portability of an applicable exclusion amount to a new spouse.

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. Couples engage in sophisticated estate planning to assure that each spouse uses the GST exemption, and, therefore, portability of the GST exemption would simplify planning for married couples and provide a remedy for disparate treatment.[325]

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. Everything that has been said about the portability of the applicable exclusion amount also could be said about the "ride up the rate brackets," represented by the progressive estate and gift tax rate schedule. In practice, however, the rates are approaching an essentially flat tax, and very little "estate equalization" planning is done any longer to take advantage of the lower rate brackets. Additionally, the fact that estate equalization entails the payment of a tax at the first spouse's death has operated as a deterrent to couples. Thus, Congress would neither significantly simplify planning for married couples nor provide a remedy for disparate treatment if it permitted portability of lower rate brackets.

§ 18. Valuation Discounts and Chapter 14 Valuation Rules

The value of property for transfer tax purposes is the price that a hypothetical willing buyer would pay to a hypothetical willing seller, neither being under compulsion to buy or to sell and both having reasonable knowledge of the relevant facts.[326] The application of this valuation rule works fairly well if an active market exists for a particular asset, such as a publicly traded security. The application of the rule does not work well, however, for property for which no active market exists. The rule has proven to be difficult to apply to closely held businesses, investment entities, real estate, unique tangible personal property, fractional interests in tangible property, and temporal interests in any type of property.

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[325] This does not mean that every taxpayer will have the same amount of GST exemption and applicable exclusion amount available, because taxpayers may use their applicable exclusion amounts for transfers for which they have allocated no GST exemption. Moreover, taxpayers may have used their applicable exclusion amounts for lifetime gifts before 1987, which is when the GST tax went into effect.

[326] Treas. Reg. §§ 20.2031-1(b), 25.2512-1.

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.

Current Law. The valuation of an interest in a closely held business or investment entity presents two different kinds of issues under current law. The first issue is the determination of a value for the business or entity as a whole. This value is the price that a hypothetical willing buyer would pay and a hypothetical willing seller would accept for the entire business or entity. In the absence of an active market for these entities, this price generally will reflect a discount for lack of marketability. The second issue has to do with whether the interest, which the transferor conveys, is a controlling interest. If not, generally the value will reflect a discount for lack of control. The discount is necessary to account for the economic reality that a hypothetical willing buyer would not be willing to pay a price equal to the interest's pro rata share of the value of the business or entity as a whole. Similar valuation issues arise with respect to fractional interests in tangible property, such as real estate or art.

Current law permits taxpayers to structure and transfer ownership interests in a manner that decreases the aggregate value of property subject to a wealth transfer tax.[327] Although existing or future lack of harmony among family members may make it impossible for a family to recapture the loss in value caused by fractionalization, many taxpayers seem willing to run this risk in order to achieve transfer tax valuation discounts. For example, a taxpayer who owns 100 percent of the shares of a corporation and is willing to relinquish control over it, can reduce the value of the property that will be subject to estate tax by giving or selling during life interests representing 51 percent of the corporation. A married taxpayer can make gifts of a 51 percent interest with little gift tax exposure by transferring a 49 percent interest to a spouse and a 2 percent interest to a child. A taxpayer can sell a 51 percent (or 49 percent) interest with little income tax exposure, if the taxpayer makes the sale to a trust that IRC § 671 considers a grantor trust. A taxpayer can reduce the value of tangible property, such as real estate or art, by giving or

[327] Before 1993, the government generally denied valuation discounts for partial interests in an entity or property when related persons owned sufficient interests in the entity or property to control significant decisions. It argued that ownership by related persons created a "unity of ownership and interest" and that the interests owned by individuals who are related to other owners and who together have control should be "valued as part of that controlling interest." Rev. Rul. 81-253, 1981-2 C.B. 187, 188 (revoked by Rev. Rul. 93-12, 1993-1 C.B. 202). Courts almost uniformly rejected the government's position, because they viewed it as inconsistent with the willing buyer/willing seller test, which Treasury's own regulations establish. Because the valuation process focuses on a hypothetical buyer and seller, the courts concluded that a valuation discount for lack of control should be available regardless of the relationship among persons who actually own other interests in the entity or property The discount for lack of control is available, for example, even if related persons own interests in the entity or property that effectively give them control over it. The discount also is available even if the individual who is making the transfer of an interest in the entity or property has control of it at the time of the transfer. *See, e.g.*, Estate of Watts v. Commissioner, 823 F.2d 483 (11th Cir. 1987); Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982); Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981). In 1993, the government abandoned its attempt to impose what amounted to a family attribution rule. It ruled that a donor who gave a 20 percent interest in a corporation to each of five related donees could value each gift without regard to the relationship between the donor and the donees or among the donees. It would allow a minority discount even if the "transferred interest, when aggregated with interests held by family members, would be a part of a controlling interest." Rev. Rul. 93-12, 1993-1 C.B. 202, 203.

selling undivided interests in that property. A 90 percent undivided interest in a painting or piece of real estate is not worth 90 percent of the value of the entire painting or piece of real estate to a hypothetical buyer, because that buyer would not be able to sell the property without either the consent of the other owners or a partition proceeding.

The law does not limit the potential for reducing transfer taxes to taxpayers who own controlling interests in businesses or who own valuable tangible property. Current law appears to permit taxpayers to create valuation discounts by transferring any kind of property into an entity such as a corporation, limited partnership, or limited liability company. The law values gifts of nonvoting shares, limited partnership interests, or voting shares or membership interests that do not control the entity at a discount from their pro rata share of the value of the assets held in the entity. A valuation discount is available for estate tax purposes as well, if the taxpayer disposes of sufficient interests during life and no longer holds a controlling interest at death.

Not all of the valuation discounts available to donors during life are available at death. The estate tax law requires an estate to value its interests in a particular entity or property with reference to all of the decedent's ownership interests in that entity or property. For example, if a decedent dies owning 100 percent of the shares of a corporation and bequeaths 20 percent of the stock to each of five different legatees, the law values the stock at 100 percent of the value of the corporation as a whole. In contrast, if the taxpayer gives a 20 percent interest in the corporation to each of five donees during life, each gift enjoys a valuation discount. Moreover, if the decedent bequeaths a minority interest in the corporation to a charity or to a spouse, the estate tax law bases the amount of the charitable or marital deduction on the value of the interest that passes to the charity or spouse. This value will reflect the discounts for lack of marketability and control.[328] This is the result, even if the taxpayer bequeaths all of the stock in a deductible manner. For example, if a decedent bequeaths 20 percent of a wholly owned corporation to each of five different charities and the corporation as a whole is worth $1 million, the decedent's gross estate would include the $1 million value, but the five charitable deductions each would be less than $200,000.

An additional set of valuation issues arises under IRC §§ 2701, 2703, and 2704. Congress intended IRC § 2701 to discourage the use of corporate or partnership valuation freezes.[329] These include *Dean-Hartzel* type recapitalizations of family corporations.[330] In general, IRC § 2701 values gifts of junior equity interests in corporations or partnerships made to a transferor's spouse or lineal descendants as if they included the value of retained preferred interests, unless the preferred interests meet certain tests. IRC § 2701 seems to have worked about as well as intended.

Congress intended IRC § 2703 to prevent the use of agreements, such as shareholder and partnership agreements, that restrict transferability or give other parties the right to acquire property for less than fair market value, to reduce artificially the value of the property subject to

[328] Estate of Chenoweth v. Commissioner, 88 T.C. 1577 (1987).

[329] When Congress enacted Chapter 14 to eliminate perceived valuation abuses involving freezes, it explicitly did not restrict the use of discounts for minority interests in family-controlled entities. H.R. CONF. REP. NO. 101-965, at 1132–34 (1990).

[330] *See* Dean v. Commissioner, 10 T.C. 19 (1948), *acq.*, 1949-1 C.B. 1; Hartzel v. Commissioner, 40 B.T.A. 492 (1939), *acq.*, 1939-2 C.B. 16.

these types of agreements. The statute requires the agreements to be disregarded in valuing property, except in the case of an agreement that is a bona fide business arrangement, not a device to transfer property to family members for less than adequate and full consideration in money or money's worth, and has terms comparable to similar arrangements entered into by persons in an arm's length transaction. IRC § 2703 appears to work appropriately in the case of agreements that restrict transfers of interests in entities. Several courts have decided that IRC § 2703 does not apply to the property interests held by such entities.[331]

IRC § 2704(a) imposes gift or estate tax on a transfer of value that results from a lapse of voting or liquidation rights.[332] IRC § 2704(b) requires that most restrictions on liquidation be disregarded in valuing interests in a family-controlled entity. IRC § 2704(b)(3)(B), however, exempts state law restrictions from the application of IRC § 2704(b). Therefore, taxpayers may use entities, such as family limited partnerships, that by state law restrict the liquidation rights of limited partners in order to achieve valuation discounts. Changes in state law that allow restrictions on liquidation significantly have limited the statute's effectiveness.

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.[333] 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.[334] 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.

Valuation controversies may lessen if the wealth transfer tax rates are the same as the tax rates on capital gains. Under the assumption that the tax law allows a basis adjustment at death under IRC § 1014, the transfer tax saved as a result of a discount is offset by an increase in tax liability on the capital gain. Even if rates are the same, however, the discount permits tax deferral until the recipient of the property sells it.

Reliance on the traditional willing buyer/willing seller approach is the source of the issues that arise with respect to the valuation of interests in entities and in unique tangible properties. The difficulty is identifying alternative valuation rules that resolve these issues without creating a different set of problems. Several valuation approaches that Congress could adopt, either singly or in combination, are discussed below.

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[331] *See* Estate of Strangi v. Commissioner, 115 T.C. 478 (2000) (holding that the "property" within the meaning of IRC § 2703(a)(1) and (a)(2) is the partnership interest, not the underlying property of the partnership), *aff'd in part, rev'd in part*, 293 F.3d 279 (5th Cir. 2002), *on remand* T.C. Memo. 2003-145, 85 T.C.M. (CCH) 1331 (2003); *accord* Church v. United States, 268 F.3d 1063 (5th Cir. 2001) (per curiam), *aff'g* 2000-1 U.S.T.C. (CCH) ¶ 60,369 (W.D. Tex. 2000).

[332] Congress enacted this statute to overturn the result in Estate of Harrison v. Commissioner, T.C. Memo. 1987-8, 52 T.C.M. (CCH) 1306 (1987). In *Harrison*, the conversion of a general partnership interest to a limited partnership interest at the death of the decedent caused the decedent's right to liquidate the partnership to lapse. The estate's interest in the partnership was valued at a discount from net asset value due to restrictions on liquidation. IRC § 2704(a) would preclude the same result today by imposing estate tax on the loss of value caused by the lapse of the decedent's liquidation right.

[333] For further discussion of the gift tax after repeal of the estate and GST taxes, see *supra* Part II.

[334] For further discussion of the modified carryover basis rule and its reliance on fair market value, see *supra* § 7.

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 could, for example, adopt a rule that values an interest in certain family-controlled entities at an amount equal to its pro rata share of the value of the entity as a whole, but that permits a uniform discount as a safe harbor. In addition, Congress could specify safe harbor multiples for the capitalization of earnings of specified business entities. Congress further could develop special rules to deal with multiple levels of discounts for tiered entities. The amount of the safe harbor could vary with the type of business or type of entity. For example, Congress could decide that one level of discount is appropriate for a business entity and another for an investment entity, and different capitalization rates could apply for different industries or during particular economic cycles.[335]

The advantage of guidelines and safe harbors is that they reduce controversies. One disadvantage, however, is that they may encourage taxpayers who might not otherwise transfer their assets to family-controlled entities to do so to achieve the statutorily prescribed discount. Another problem is that, if the government construes a safe harbor discount as a ceiling on permissible valuation discounts, the safe harbor would have the effect of denying legitimate discounts in excess of the safe harbor, with the result that the government would overtax some taxpayers because it overvalued their interests. On the other hand, the permissible valuation discounts may become a floor, with the result that the government would undertax some taxpayers because it undervalued their interests. One response to these concerns would be for Congress to provide for a retroactive adjustment of the 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. Representatives from various professional groups who have knowledge of the actual practices and realities involved could participate in the development of the revenue procedure. The consultation process could be similar to that used in the development of Revenue Procedure 64-19, having to do with the funding of pecuniary marital deduction bequests.

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. If the entity conducts an active business—defined in accordance with IRC § 6166, which provides for deferral of estate taxes attributable to a closely held business—Congress could treat reasonable capital needs of the business as part of the active business.[336] This approach would discourage taxpayers from creating valuation discounts by placing assets in

[335] *Cf.* IRC § 7520 for an example of Congress directing Treasury to prescribe tables for valuation purposes.

[336] Congress should not necessarily base the standards for determining the "reasonable capital needs of the business" on formulas used to apply the accumulated earnings tax imposed by IRC § 531, et seq. For further discussion of IRC § 6166, see *infra* § 25.

investment entities. However, the definition of "nonbusiness assets" could prove to be difficult and may invite artificial transactions in search of a different classification.

The difficulty with this proposal is its breadth. It would have an impact on taxpayers who played no role in creating the valuation discounts, which arise from other taxpayers having placed assets in an investment entity. These taxpayers may never have had any access to the underlying wealth that their interests in the entity represent, and therefore it may not be appropriate to subject them to tax on such wealth. The following example demonstrates the problem of the proposal's overinclusiveness.

> *Example: Noncontrolling interest in an investment partnership. G* dies owning a 10 percent interest in an investment partnership controlled by her mother, *M*. The assets held by the partnership are worth $1 million at *G*'s death. *G* had received the interest gratuitously from *M*. It is difficult to justify valuing the partnership interest at $100,000 when neither *G* had nor *G*'s estate has the ability to receive $100,000 for that interest without the cooperation of the controlling partner, even if that controlling partner is *M*.

Because family members do not always act in harmony, an attempt to tax a minority interest based on its proportional share of the net asset value of a nonbusiness entity could be viewed as punitive.

3. <u>Aggregate Family and Donatively Transferred Interests</u>. 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.[337] This approach would disallow minority discounts for all transfers except arms' length transfers to nonfamily members, unless all interests held by the transferor and family members would qualify for the discounts. This proposal may be too broad because it could permit the government to tax a value that a transferor neither possessed nor had any opportunity to possess.

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. Under this approach, at the time of a lifetime or deathtime transfer, the value of a partial interest in property for the purpose of the transfer taxes would equal that partial interest's pro rata share of all interests in that property that: (i) the transferor owned at such time and (ii) other persons owned at such time, to the extent that the transferor had transferred those interests to those other persons, except for interests transferred to nonfamily members in arms' length transfers. To prevent circumvention of this rule, it may be necessary also to include interests that family members acquired in exchange for capital contributions. If this approach were adopted, it also would be necessary to change the gift tax law to protect individuals from gift tax liability when they purchase fractional interests in property from family members and pay a purchase price equal to the pro rata share of

[337] An approach similar to the one described here was included in the Omnibus Budget Reconciliation Act, H.R. 3545, 100th Cong. § 10108 (1987), as passed by the House of Representatives in 1987. The conference committee rejected it. H.R. CONF. REP. NO. 100-495, at 995 (1987).

the total value of the property that corresponds to the purchased fractional interest. Although this approach would discourage taxpayers from creating entities solely to obtain valuation discounts, it also could overvalue interests in family-owned entities that were created for bona fide business purposes.

This alternative can be illustrated by the following examples:

> *Example 1: A gift to a family member, a sale to a family member, and a bequest by a 100 percent owner. G* owns all of the stock of *XYZ Corporation*. In year 1, *G* gives a 26 percent interest in *XYZ* to *G*'s child, *B.* In year 2, *G* sells a 26 percent interest in *XYZ* to another child, *C*. In year 3, *G* dies. At the time of *G*'s death, *G* owns 48 percent of *XYZ* and each child owns 26 percent of *XYZ*. At all times, the value of *XYZ* is $1 million. The 26 percent interest that *G* gave to *B* has a value for gift tax purposes of $260,000 (26 percent x $1 million). The pro rata valuation rule prevents a valuation discount because *G* and *B* together control *XYZ*. The 26 percent interest that *G* sold to *C* also has a value for gift tax purposes of $260,000. Again, the pro rata valuation rule prevents a valuation discount because *G*, *B* (a donee), and *C* (a family member to whom *G* sold *XYZ* stock) together control *XYZ*. The 48 percent interest in *XYZ* owned by *G* at the time of *G*'s death has a value for estate tax purposes of $480,000 (48 percent x $1 million). Once more, the pro rata valuation rule prevents a valuation discount because *G*, *B*, and *C* together control *XYZ*. *G*'s estate would receive a marital or charitable deduction of $480,000, if *G* were to bequeath the 48 percent interest in *XYZ* to *G*'s spouse or to a charity.

> *Example 2: A bequest by a donee of a fractional interest.* Donee *B* from example 1 dies owning 26 percent of *XYZ Corporation*. At the time of *B*'s death the value of *XYZ* is $1 million, *G* owns 48 percent of *XYZ*, and *C* owns 26 percent of *XYZ*. The value for estate tax purposes of *B*'s 26 percent interest in *XYZ* is not necessarily equal to 26 percent of the value of *XYZ*. The pro rata valuation rule does not apply because *B* never had a controlling interest in *XYZ*.

> *Example 3: A sale to a nonfamily member. G* owns all of the stock of *ABC Corporation*. *G* sells 30 percent of that stock to *E*, a nonfamily member, when the value of *ABC* is $1 million. The pro rata valuation rule will not apply because *E* is not a member of *G*'s family. This result may seem inappropriate because it would require *G*, in order to avoid the gift tax, to charge a higher price for the sale of the stock to a family member than to a stranger. Congress could provide exceptions to the aggregation rule if the transferor engages in arms' length sales and the sales involve more than nominal interests.

> *Example 4: A sale to a family member and a sale to a nonfamily member. G* owns all of the stock of *MNO* Corporation. In year 1, *G* sells 49 percent of the stock of *MNO* to *G*'s child, *A*. In year 2, *G* sells 2 percent of the stock of *MNO* to *E*, a nonfamily member. In year 3, *G* dies owning 49 percent of the stock of *MNO*. At all times, the value of *MNO* is $1 million. The pro rata valuation rule will apply to the sale to *A* because *A* is a member of *G*'s family. Thus, *A* must pay $490,000 (49 percent x $1 million) for the transfer to qualify as a sale for adequate and full consideration in money or money's worth. The pro rata valuation rule will not apply to the sale to *E* because *E* is not a member of *G*'s family. The pro rata valuation rule will apply to *G*'s estate because *G*'s *MNO* stock will be aggregated with the *MNO* stock previously sold to *A*. Thus, the 49 percent interest in *MNO* owned by *G* at the time of *G*'s death has a value for estate tax purposes of $490,000 (49 percent x $1 million).

Congress could refine this pro rata valuation rule by limiting it to interests held on, or acquired after, the effective date of the statute. The pro rata valuation rule, therefore, would deny only discounts generated by fractionalizations completed after the effective date of the new law, but would respect fractionalizations in place before the effective date (subject to the valuation rules of current law, including IRC §§ 2701, 2703, and 2704, that might affect preexisting fractionalizations). This effective date rule is similar to the one for IRC § 2704, which generally applies only to rights and restrictions created after that statute's effective date.[338] Thus, for example, if an individual creates a partnership and begins to transfer interests in it after the legislation's effective date, the new provision would value each transferred interest at precisely its proportionate share of the value of the entire partnership. If, however, that individual (and relevant family members) never owned more than, for instance, a 40 percent interest in the partnership on the effective date of the legislation and later transfers a 5 percent interest, the pro rata valuation rule would value that interest at one-eighth (5 percent ÷ 40 percent) of the value of a 40 percent interest and not 5 percent of the value of a 100 percent interest.[339] With advance planning, however, a taxpayer may be able to avoid the adverse tax consequences of the pro rata valuation rule by placing 100 percent of an interest in one entity into another entity in which the taxpayer owns only a 49 percent interest.

4. <u>Recapture Discounts for Lack of Control</u>. 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.[340] The recapture rule would tax the portion of the gain attributable to the discount at the highest transfer tax rate then in effect. Congress could make discount recapture elective, meaning that the transferor or executor of a taxpayer's estate could choose whether to have an interest valued on a discounted or nondiscounted basis for transfer tax purposes. The recapture rule would not apply to a later sale of the asset if the transferor or executor elects a nondiscounted valuation. If the transferor or executor elects to use a valuation discount, however, a later sale of the asset at a gain would result in the application of the recapture tax.

An advantage of this approach is that it would not immediately impose a transfer tax on that portion of the value of an interest in an asset that the transferee cannot realize without the cooperation of other owners of interests in the asset. Instead, it would defer that tax until the transferee actually realizes a higher value by a sale of the interest to a third party under circumstances in which the buyer does not discount its value. The disadvantage is its complexity. It would require the transferee to maintain the original appraisal of the transferred interest in an asset until that interest is sold.[341] In addition, it would require an appraisal at the time of sale to determine that portion of the price that is attributable to the prior discount. It also would require tracing, so as to preserve recapture in replacement assets or in the hands of a gratuitous

[338] Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602(e)(1), 104 Stat. 1388–500.

[339] The 1987 House-passed rules and the Clinton Administration budget proposals arguably were too broad, because they would have valued the 5 percent based on the value of the whole entity. *See* H.R. REP. NO. 100-391, at 452 (1987); 1997 Budget Bill Submitted to Congress, Mar. 19, 1996, *reprinted in* DAILY TAX REP. (BNA) No. 55, at S-67 to S–69 (Supp. Mar. 21, 1996).

[340] Congress could consider making an exception for a disposition of the interest to another family member. *Cf., e.g.,* IRC § 2057(f)(1)(B) (having to do with the recapture rule for family-owned business interests that obtained a deduction under this provision). The EGTRRA repealed IRC § 2057 for decedents dying after 2003 and reinstated it for decedents dying after 2010. IRC § 2057(j); EGTRRA § 901.

[341] Congress could consider imposing liens on the interests, or if liens are not acceptable, requiring bonds, to secure the recapture tax.

transferee of the original transferee. Another problem with this approach is that some may view taxation at the highest marginal rate as punitive. This approach is illustrated by the following example.

> *Example: A gift and subsequent sale of an interest in an entity. G* owns all of the stock of *XYZ Corporation*. In year 1, the value of *XYZ* is $1 million. In year 2, *G* gives 20 percent of *XYZ* stock to *G*'s child, *B*. A hypothetical willing buyer would demand a 25 percent discount from the pro rata share of the value of *XYZ*. *G* elects to value this gift at $150,000 (75 percent of $200,000), the value that a hypothetical willing buyer would pay for it, rather than at an amount equal to its pro rata share of the value of *XYZ* ($200,000). In year 3, *G* and *B* sell all of the *XYZ* stock to *C* for $2 million. *B* receives $400,000 for 20 percent of the stock. At that time, the market discounts *B*'s interest by 35 percent, rather than the 25 percent used to value *G*'s gift to *B*. As a result, *B* would have received only $260,000 (65 percent x $400,000) for *B*'s 20 percent interest in *XYZ*. Under the recapture rule, *B* will pay an additional tax ("recapture tax") attributable to the discount.
>
> There are several ways to calculate the recapture tax. One is to impose recapture tax on the proportion of the proceeds equal to the percentage discount allowed for transfer tax purposes when the transferor acquired the property, i.e., 25 percent of the proceeds, or $100,000 (25 percent x $400,000). A second way is to impose a recapture tax on the amount of the proceeds that exceeds the amount *B* would have obtained had *B* sold *B*'s minority interest to a hypothetical purchaser, i.e., 35 percent of the proceeds, or $140,000 (35 percent x $400,000). A third way to compute recapture is on the absolute amount of the discount allowed on the original transfer, or $50,000 ($200,000 – $150,000).

5. <u>Treat Diminutions in Net Worth as Taxable Gifts</u>. Congress could treat diminutions in net worth as taxable gifts. This approach would eliminate the disparity between the estate tax and gift tax valuation rules. This approach is illustrated by the following example.

> *Example: A majority shareholder relinquishes control through the lifetime transfer of a minority interest. G* owns 51 percent of the stock in a family business.[342] He transfers 2 percent of it to his wife, *W*. The diminution rule values *G*'s gift by determining the difference in value between *G*'s 51 percent controlling ownership interest before the transfer and *G*'s 49 percent minority ownership remaining after the gift. A gift to *W* could be taxable, notwithstanding the marital deduction, because the law determines the value of the marital deduction by what a spouse receives (i.e., the 2 percent interest subject to a valuation discount), rather than what the taxpayer relinquishes.[343] If *G* still owns the remaining 49 percent interest at death, the estate tax rules would value it as a minority interest. In the aggregate, the two transfers (one during life and one at death) would generate combined estate and gift tax liability that is the same as what it would have been had the taxpayer made both of the transfers at death. The total tax liability is the same because, in both instances, the taxpayer pays a transfer tax on majority control.

6. <u>Coordinate the Estate and Gift Tax Valuation Rules</u>. Congress could change the estate tax valuation rules to conform to the current gift tax treatment. For example, as discussed above, under current law, if a donor owns 100 percent of a corporation and makes lifetime gifts of a 20 percent interest in the corporation to each of five individuals, the law values each of the

[342] Congress could incorporate an aggregation rule into the diminution rule, so that *G*'s ownership of 51 percent could be an aggregation of interests held by other family members.

[343] If Congress were to adopt an approach that would take into account the diminution in net worth upon a lifetime transfer, it would need to give consideration to the implications that approach might have in community property jurisdictions, which frequently embrace presumptions that favor categorizing property owned by spouses as community property.

interests as noncontrolling interests. In contrast, if the same donor dies and bequeaths a 20 percent interest in the same corporation to each of five individuals, current law imposes an estate tax on the value of the corporation as a whole. This alternative would value the five bequests as five separate minority interests for estate tax purposes. In effect, this alternative converts the federal estate tax into a federal inheritance tax, because it would tax the value of what each recipient receives and not what each decedent bequeaths.

In contrast to a number of the other alternatives described above, which eliminate or offset the valuations resulting from fractionalization of interests in an asset, alternatives 2 through 5 target, in particular, the technique of making fractional transfers during life, including gifts to multiple donees, and retaining only fractional interests at death. Generally, they attempt to conform the treatment of both the fractional gifts and the fractional interests held by a decedent at death to the current estate tax model of valuing all interests held by a decedent at death as a unitary holding, regardless of fractional dispositions of those interests by the decedent at death.

Like alternatives 2 through 5, which reduce the significance of fractionalization, this alternative reduces or eliminates the difference between the estate tax and the gift tax valuation rules. Moreover, this alternative allows a person with multiple beneficiaries to achieve a result at death that now is available only through sophisticated lifetime planning, thereby simplifying administration of, and compliance with, the wealth transfer tax system. The disadvantage of this alternative, however, is that it extends rather than restricts reliance on opinions of fractionalization discounts.

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.[344] 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. The "subtraction method," imposed by Treas. Reg. § 25.2701-3(b), assumes that there is only one valuation method that appraisers can apply to a closely held corporation and that appraisers could not apply the statutory mandate to treat nonqualified payment rights as valueless under other valuation models. For example, under a cash flow determination of the value of an equity interest, appraisers could regard a nonqualified payment right as valueless and refuse to subtract the nonqualified payment obligation in determining the net cash flow of the entity. The subtraction method does not accommodate, or appear to even acknowledge, this technique.[345]

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

[344] The special valuation rules found in IRC §§ 2701, 2703, and 2704 would be unnecessary in most cases if Congress were to address valuation discounts under one of the other alternatives.

[345] In addition, Treasury could mitigate the imputed holding rules. For example, it could treat IRC § 2701 as inapplicable to a situation in which all the owners of the common stock of a corporation receive new preferred stock in proportion to their holdings of the common stock, even though some of the stockholders may happen to be trusts. Priv. Ltr. Rul. 93-21-046 (May 28, 1993).

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.[346] Although a procedure of this kind would be useful for taxpayers, it likely would not be cost-effective for the government to administer, because it would apply to many tax returns for which no tax is due. User fees, which would be similar to the charges the IRS now imposes in connection with ruling requests, could mitigate the cost to the government of issuing the advance rulings.

B. Valuation of Temporal Interests in Property

Issue: <u>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.</u>

Current Law. A temporal interest in property is a possessory interest that will end at some time in the future or a nonpossessory interest that will commence in possession in the future. Transferors frequently create temporal interests by transferring property in trust, directing how the beneficiaries are to share or benefit from the property. For example, the trust instrument may direct the trustee to pay the income from the transferred property to one beneficiary, or permit one beneficiary to enjoy possession of the trust property, for a specified period and, upon the expiration of the period, to distribute the transferred property to another beneficiary.

The value of a gift for transfer tax purposes is not determined by reference to the hypothetical willing buyer/willing seller test when a transferor gives a temporal interest in property and retains another temporal interest. IRC § 7520 requires the transferor to determine the value in accordance with actuarial tables prescribed in IRC § 7520. The actuarial tables are based on an interest rate (determined monthly) equal to 120 percent of the federal midterm rate in effect under IRC § 1274 on the date of the gift.

The method of valuation under IRC § 7520 achieves administrative convenience in that it is easy to determine the value of a temporal interest. Because the method of valuation under IRC § 7520 is determined by reference to past interest rates, the valuation may not be an accurate predictor of future value. This method of valuation produces an accurate result only through a combination of the following circumstances: (i) the property produces an income stream consistent with the IRC § 7520 interest rate (120 percent of the applicable federal midterm rate), and (ii) the value of the property does not increase or decrease during the term. In addition, the valuation ignores the income tax cost of receiving a stream of taxable income. Because taxpayers and their advisers will attempt to select assets and, if applicable, measuring lives that are most likely to "beat" the valuation and actuarial tables, taxpayers have a greater chance of taking advantage of the valuation method. However, the significant decline in the equities markets during the late 1990s illustrates the difficulties taxpayers face in trying to select assets that will outperform the valuation tables.

[346] Rev. Proc. 96-15, 1996-1 C.B. 627, establishes such a procedure for the valuation of art, but it is not available until after a donor has made a gift.

IRC § 2702 creates another valuation problem with temporal interests. Since 1990, IRC § 2702 has reduced, but has not eliminated, the likelihood that taxpayers will use gifts of undervalued temporal interests to reduce transfer taxes. IRC § 2702 values a gift of a temporal interest in property to certain family members as if the gift includes any preceding or subsequent temporal interest in the property that the donor retains. Because a gift of a temporal interest in property is not worth the value of the entire property, IRC § 2702 has discouraged donors from making a gift of a temporal interest, unless the gift falls within one of several exceptions to IRC § 2702.

There are three important exceptions to IRC § 2702. First, IRC § 2702 does not apply to all gifts, but only to gifts made to a donor's spouse, a descendant or an ancestor of the donor or the donor's spouse, a sibling of the donor, or a spouse of any such descendant, ancestor, or sibling. IRC §2702 does not apply to gifts to nieces, nephews, domestic partners, or friends. Second, IRC § 2702 does not apply to a gift of a remainder interest in property that follows a retained right to receive certain annuity payments. This exception excludes from the gift tax all of the future investment return on a particular asset in excess of the current IRC § 7520 rate. After the ruling in the Tax Court case *Walton v. Commissioner*, a donor may structure a grantor retained annuity trust so that the remainder interest has a nominal value.[347] If the trust property produces an investment return in excess of the IRC § 7520 rate and the donor outlives the term of the trust, the remainder beneficiary will receive property free of any transfer tax. If the trust property produces a return of less than the IRC § 7520 rate, the trust property simply returns to the donor in the form of annuity payments, and there is no adverse impact on the donor's transfer tax situation.

A third exception is that IRC § 2702 does not apply to certain gifts of interests in personal residences. This exception permits a donor to make a gift of a remainder interest in a personal residence and to calculate the value of the gift using the IRC § 7520 rate.[348] Generally, the valuation method will overvalue the retained term interest in the residence and undervalue the gift of the remainder interest. The exception also applies the valuation method to a situation in which the taxpayer purchases a term interest in a residence at the same time that family members purchase the remainder.

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.[349] Therefore, the alternatives set forth below are relevant regardless of whether Congress retains the estate and GST taxes.

Reliance on the IRC § 7520 actuarial tables is the source of the concerns that arise with respect to the valuation of temporal interests. The difficulty in valuing those interests for which there is no market is to structure an alternative that would not create significant administrative burdens. Three possible modifications to current law are set forth below.

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[347] 115 T.C. 589 (2000), *acq*., 2003-44 I.R.B. 964.

[348] IRC § 2702(a)(3)(A)(ii).

[349] For further discussion of the gift tax after repeal of the estate and GST taxes, see *supra* Part II. Valuation of temporal interests is not a significant issue under the modified carryover basis rule, because most temporal interests are held in trust and the modified carryover basis rule applies to the underlying assets used to fund the trusts. For further discussion of the modified carryover basis rule of IRC § 1022, see *supra* Part III.

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. IRC § 2702 does not apply to gifts to any individual other than the donor's spouse, a descendant or an ancestor of the donor or the donor's spouse, a sibling of the donor, or a spouse of any such descendant, ancestor, or sibling. If Congress believes that IRC § 2702 establishes the correct valuation rule for gifts to certain related donees, it would seem reasonable to apply IRC § 2702 to gifts to all donees, regardless of their relationships to the donors.

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.[350] IRC § 2702 allows a transferor who creates an annuity trust to retain an annuity with a value equal to virtually the entire value of the property transferred to the trust. This type of trust permits the transferor to retain all of the risk of loss while giving to the remainder beneficiaries all of the benefit of gain in excess of the IRC § 7520 rate. This imbalance makes it likely that IRC § 2702 undervalues the remainder interest. A specified minimum value would require a taxpayer to use a portion of the taxpayer's applicable exclusion amount or to pay gift tax when the taxpayer makes a gift of a remainder interest following the taxpayer's retained annuity interest. If a minimum value is required for the remainder interest, the transfer tax technique is no longer risk free.

3. 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. 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. Either approach would eliminate the current difference in the treatment of personal residences under the estate tax and the gift tax laws.

§ 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.

Current Law. The wealth transfer tax system values property at its fair market value, which is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[351] The regulations go on to indicate that the market for applying this test is the "retail market."[352] As a result, the general valuation rules require a determination

[350] IRC § 2701, which deals with a similar valuation issue, requires that the junior equity in a corporation or other entity be worth at least 10 percent of the value of the entity.
[351] Treas. Reg. § 20.2031-1(b). *See also* Treas. Reg. § 25.2512-1.
[352] Treas. Reg. §§ 20.2031-1(b), 25.2512-1.

of what a purchaser would pay for the property (sometimes described as the replacement cost or retail value) rather than the net value the seller would receive (sometimes described as the liquidation value or the wholesale price).[353]

Because the replacement cost is generally greater than the price a person could receive upon the sale of the same property, the regulations provide that, if the sale actually occurs in order to pay "debts, expenses of administration, or taxes, to preserve the estate, or to effect distribution," under IRC § 2053, the estate can deduct the differential in value as an expense of administration.[354] Thus, replacement cost results in a higher tax value, unless an estate actually sells an asset for one of the reasons described above.

A justification for the use of replacement cost is that retained assets are worth what the beneficiaries would have had to pay to purchase them. The flaw in this logic is that a beneficiary may not wish to retain an asset, but, so long as its sale is not necessary in the proper administration of the estate, the differential in value between replacement cost and liquidation value is not deductible.[355] The valuation rules, therefore, value identical assets differently, depending on the vagaries of an estate's administration needs.

Moreover, if the purpose of the transfer tax is to impose an excise on the right to transfer wealth, computation of the tax arguably should be based on the value of the asset to the transferor, which would be what the transferor could obtain if the transferor sold the property. The fact that a decedent could direct an executor to sell all the assets in an estate and distribute only the proceeds from the sales to the estate beneficiaries underscores the strength of this argument. This direction would permit the executor to use liquidation values when valuing the assets. That would be the case even if the executor sells the assets to a beneficiary of the estate.

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. The length of time that the regulations requiring the use of replacement costs have been in place suggests that statutory, rather than regulatory, amendment is necessary. The advantage of this approach is that it reduces the likelihood that the different administrative needs of an estate will lead to different valuations of similar assets.

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. The difference between the potential net proceeds of sale and the replacement cost most readily is apparent with tangible personal property, such as an automobile, in which the cost of buying the tangible personal asset

[353] Liquidation value refers to liquidation of a taxpayer's interest in property and not liquidation of an entity, such as a corporation or partnership, in which the taxpayer owns an interest. Thus, liquidation value is not the same concept in this context as when it is applied to an entity valuation measured by the liquidation value of the entity's assets. Here, liquidation value refers only to the amount the taxpayer would receive upon the sale of assets owned by the taxpayer at the time of the taxable transfer during life or at death.
[354] Treas. Reg. § 20.2053-3(d)(2).
[355] *See id.*

from a dealer can be substantially greater than the amount received upon selling that same asset to that same dealer. The advantage of Congress's adopting this more limited alternative is that it responds to those cases that taxpayers perceive as particularly unfair.

§ 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).

Current Law. The wealth transfer tax system uses the same rate table for both estate tax and gift tax purposes, but the *effective* gift tax rates are lower than the *effective* estate tax rates because the estate tax is "tax inclusive."[356] That is to say, IRC § 2001 applies the appropriate tax rates to the value of a decedent's entire estate, including the dollars that the estate will use to pay the estate tax. In contrast, the gift tax is "tax exclusive." That is to say, IRC § 2502 applies the appropriate tax rates to the value of the property that the donor transfers, which does not include the dollars that the donor directly, or indirectly, uses to pay the gift tax.[357]

> *Example: A comparison of the tax base for deathtime and lifetime transfers. G* dies with a will bequeathing her entire estate to *C*. She has an estate of $1.5 million, subject to tax at the rate of 50 percent.[358] The estate tax on the $1.5 million is $750,000 (50 percent x $1.5 million), leaving *C* only $750,000. If, while *G* had been alive, she had made a gift of $1 million to *C*, which also would have been subject to tax at the rate of 50 percent, *G* would have paid a gift tax of only $500,000. Notwithstanding that the two transfers were subject to the same tax rate, the tax exclusivity of the gift tax means that *C* would have received $1 million during life, rather than only $750,000 at *G*'s death, when the tax inclusive estate tax applies.[359]

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[356] IRC §§ 2001(c), 2502(a)(1).

[357] IRC § 2502(c) makes the donor primarily liable for the gift tax. If the donor makes a gift subject to the donee paying the gift tax (referred to as a net gift), the amount of the gift tax and the amount of the gift are interdependent, but the tax base remains tax exclusive. *See* Rev. Rul. 75-72, 1975-1 C.B. 310 (providing an algebraic formula for determining the amount of the gift and the gift tax).

[358] For ease of exposition, the example assumes a tax rate of 50 percent, even though the EGTRRA provides for a scheduled reduction of the maximum transfer tax rate, so that in 2007 it goes down to 45 percent and stays at that rate through 2009. EGTRRA § 511.

[359] If both the estate and gift taxes were computed on a tax exclusive basis, i.e., without including the tax paid in the tax base, then the maximum effective estate tax rate on *G*'s estate would be 100 percent ($750,000 of estate tax on $750,000 of assets bequeathed to *C*), and the maximum effective gift tax rate on *G*'s gift would be 50 percent ($500,000 of gift tax on $1 million of assets given to *C*). If both taxes were computed on a tax inclusive basis, i.e., by including the tax in the tax base, then the maximum effective estate tax rate would be 50 percent ($750,000 of estate tax on $1.5 million of assets), and the maximum effective gift tax rate would be 33.3 percent ($500,000 of gift tax on $1.5 million of assets).

The difference between the estate tax and the gift tax encourages lifetime giving.[360] A taxpayer, however, has to weigh the advantage of tax exclusivity against the benefits of holding property until death. Those benefits include, subject to some exceptions, having the recipient receive a basis equal to an asset's fair market value at the decedent's death under IRC § 1014, rather than a carryover basis under IRC § 1015.[361] The credit for tax on prior transfers, alternate valuation, and special use valuation are some other aspects of the estate tax law that may favor transfers at death over lifetime transfers.[362]

There does not seem to be any apparent reason to favor one form of estate planning over another. Congress sometimes specifically articulates a goal of encouraging certain economic behavior, as it has done by adopting estate tax rules designed to preserve small family-owned farms.[363] Congress, however, has not articulated its intent to encourage lifetime giving.

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.[364]

1. <u>Adopt a Tax Exclusive Tax Base for the Estate Tax</u>. 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.[365] 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. <u>Adopt a Tax Inclusive Tax Base for the Gift Tax</u>. 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.[366] Adjustment of the gift tax rates leads to higher gift tax rates, which may make this alternative less desirable.

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[360] Another advantage of lifetime giving is the ability to take advantage of valuation rules. *See supra* § 18. The tax inclusive tax base for the estate tax and the tax exclusive tax base for the gift tax demonstrate that the Tax Reform Act of 1976 only partially unified the estate and gift taxes.

[361] For a comparison of the differences between lifetime and deathtime transfers upon repeal of the estate and GST taxes, see *supra* § 7.2.d.

[362] *See* IRC §§ 2013, 2032, 2032A.

[363] IRC § 2032A; H.R. REP. NO. 94-1380, at 21–22 (1976) (expressly stating a desire to preserve family farms).

[364] If Congress were to eliminate the difference in tax base between the estate tax and the gift tax, it further could consider amendments to the GST tax under IRC §§ 2603, 2621–23, which provide that direct skips are tax exclusive while taxable distributions and terminations are tax inclusive. The tax exclusive treatment of direct skips can be justified, however, on grounds other than that the GST tax on direct skips mimics the gift tax. Direct skips were controversial when enacted, and the tax exclusive treatment of direct skips may be justified as a simple mechanism for taxing these types of transfers at a lower tax rate. *See* STAFF OF THE JOINT COMM. ON TAXATION, 98TH CONG., 2ND SESS., DESCRIPTION OF GENERATION-SKIPPING TRANSFER TAX SIMPLIFICATION PROPOSALS (H.R. 6260 AND H.R. 6261) AND BACKGROUND INFORMATION, 16 (Comm. Print 1984) [hereinafter GENERATION-SKIPPING TRANSFER TAX SIMPLIFICATION PROPOSALS 1984].

[365] *See supra* notes 357 (discussion of net gifts), 359 (discussion of tax-rate adjustment).

[366] *See supra* note 359 (discussion of tax-rate adjustment).

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. A deduction for the estate tax would make the estate tax base tax exclusive. An algebraic calculation is necessary to determine the amount of the deduction for estate taxes. The reduction of the tax base may require an increase in effective rates, if Congress wants to assure that the change is revenue neutral. The justification for the deduction of the estate tax under IRC § 2053 is that it is a transmission expense. For a further discussion of the distinction between transmission and management expenses, see § 21, which immediately follows.

§ 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.

Current Law. IRC § 2053(a) permits a deduction from a decedent's gross estate for administration expenses allowable by the laws of the governmental entity that has jurisdiction over the decedent's estate. The expenses that are allowable as deductions fall into two major categories. The first category comprises "management" expenses that the estate incurs during the period of estate administration in connection with the investment or preservation of estate assets, such as investment advisory fees, stock brokerage commissions, and custodial fees. The second category comprises "transmission" expenses that the estate incurs to marshal the decedent's assets; pay debts and taxes, including tax compliance costs and appraisal fees; and distribute the estate, including commissions and attorney fees.[367] The second category also covers probate administration fees and expenses for construction of donative instruments and will contests.

Recently revised charitable and marital deduction regulations recognize that management expenses do not represent the necessary costs of transferring estate property from the decedent to estate beneficiaries.[368] Instead, the estate incurs them for the benefit of the beneficiaries. As a result, the regulations treat management expenses differently from transmission expenses.[369] Neither IRC § 2053 nor its regulations has yet embraced this distinction.

Even though management expenses are not related to the transfer of estate property, IRC § 2053 permits an estate to deduct both transmission and management expenses for estate tax

[367] The commissions and attorney fees in this category would not include those that the estate incurs to invest or preserve estate assets because those types of expenses qualify as management expenses.
[368] Treas. Reg. §§ 20.2055-3(b), .2056(b)-4(d). Treasury revised the regulations as a result of the U.S. Supreme Court's decision in *Commissioner v. Estate of Hubert*, 520 U.S. 93 (1997), which had to do with the effect on the amount of an estate's marital deduction when administration expenses are paid out of the estate's income. The regulations establish the distinction between management and transmission expenses.
[369] The regulations do not require that the amount of the charitable or marital deductions be reduced by the amount of the management expenses incurred in connection with and charged against a charitable or marital bequest.

purposes. The deduction for transmission expenses is appropriate because these expenses reflect the cost of transferring the decedent's property. If transmission expenses were not deductible, the effect would be to tax property that no beneficiary actually receives. Management expenses, however, are not part of the cost of transferring estate assets to beneficiaries. Management expenses are expenses that beneficiaries of the estate would have incurred if the executor had distributed the estate's assets to the beneficiaries immediately upon the decedent's death, rather than retained the assets in the estate during the period of administration. In addition to the possibility that a deduction for estate management expenses may be inappropriate, a deduction creates an economic incentive for executors to prolong administration of an estate to maximize deductible estate management expenses and, thereby, reduce the taxable estate.

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. Management expenses would not be deductible for the purpose of determining estate tax liability. By making management expenses nondeductible under IRC § 2053, Congress would be according these expenses treatment equivalent to the treatment of expenses under IRC §§ 2055 and 2056.

§ 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.

Current Law. Congress enacted IRC § 2013 to limit the amount of estate tax imposed on property that successive decedents have transferred within a twelve-year period. IRC § 2013 provides a credit to the estate of a recipient who obtained the property at the death of a transferor. The credit is available to the estate of the recipient if the recipient dies within two years before or ten years after the transferor dies.[370] IRC § 2013(b) and (c) provide that the credit is equal to the lesser of the estate tax imposed on the transferred property in the transferor's estate or in the recipient's estate. If the transferor dies within two years of the recipient, the recipient's estate receives 100 percent of the credit. IRC § 2013(a) reduces the credit by 20 percent every two years.[371]

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[370] IRC § 2013(a).

[371] IRC § 2013(a) provides that the credit is:

> the following percentage of the amount so determined—
>
> (1) 80 percent, if [the transferor died] within the third or fourth years preceding the decedent's death;
>
> (2) 60 percent, if [the transferor died] within the fifth or sixth years preceding the decedent's death;
>
> (3) 40 percent, if [the transferor died] within the seventh or eighth years preceding the decedent's death; and
>
> (4) 20 percent, if [the transferor died] within the ninth or tenth years preceding the decedent's death.

The credit applies to any "transfer of property" from the transferor to the recipient. IRC § 2013(e) defines "property" broadly to include any beneficial interest in property. The specific property transferred by the transferor does not have to be identified or even included in the recipient's gross estate—there is no requirement that proceeds from the property be traced to the recipient's estate.[372] The property transferred, however, must be susceptible to valuation. Furthermore, the property must have been subject to federal estate tax in the transferor's estate.[373] The following examples illustrate the application of IRC § 2013.

> *Example 1: The recipient sells previously inherited property. A* bequeaths to *B* 100 shares of *XYZ Company* stock, valued at $100 for estate tax purposes. The estate tax attributable to the 100 shares of *XYZ* stock and paid by *A*'s estate is $40. *B* sells the stock, spends the proceeds from the sale, and then dies three years after *A*'s death. *B*'s marginal estate tax rate is 50 percent. *B*'s estate will receive a credit for previously taxed property equal to $32. IRC § 2013(b) and (c) limit the credit amount to $40 (the lesser of the tax imposed on the property in *A*'s estate ($40) or *B*'s estate ($50)). IRC § 2013(a)(1) further reduces the amount by 20 percent because *B* died in the third year after *A*'s death (80 percent x $40).

> *Example 2: The recipient inherits a temporal and a discretionary interest in property.* The facts are the same as in example 1, except that *A* leaves *B*'s inheritance (the shares of stock) in trust and directs that *B* has the right to the income from the trust for life. In addition, *A* gives the trustee absolute discretion to invade the trust corpus on behalf of *B*. The value of *B*'s life estate as of *A*'s death is $50. *B*'s estate will receive a credit for previously taxed property based on the value of the life estate when *A* died, even if *B* did not live to *B*'s full life expectancy. No credit is allowed with respect to *B*'s discretionary beneficial interest in the principal of the trust, because that interest is not susceptible to valuation. The estate tax paid by *A*'s estate and attributable to the life estate in 100 shares of *XYZ* stock is $20. *B*'s estate will receive a credit for previously taxed property equal to $16. IRC § 2013(b) and (c) limit the credit amount to $20 (the lesser of the tax imposed on the property in *A*'s estate ($20) or *B*'s estate ($25)). IRC § 2013(a)(1) further reduces the amount by 20 percent because *B* died in the third year after *A*'s death (80 percent x $20).

> *Example 3: The recipient receives property by gift. A* makes a lifetime gift of the 100 shares of *XYZ Company* stock to *B* and pays gift tax of $40. *A* dies one year later, and *B* dies one year after *A* died. An estate tax in the amount of $20 is imposed on *B*'s estate for the shares *B* received by gift from *A*. *B*'s estate cannot take a credit for previously taxed property because the transfer was not subject to estate tax in *A*'s estate (the estate of the transferor).[374]

> *Example 4: The recipient inherits discretionary interests subject to the GST tax at the recipient's death. A* dies and bequeaths 100 shares of *XYZ Company* stock valued at $100 to a trust and directs the trustee to pay, at the trustee's discretion, income and principal to *A*'s daughter, *B*. Upon *B*'s death, the trust instrument provides that the trustee will distribute the corpus to *A*'s grandchild, *GC*. The estate tax attributable to the 100 shares of *XYZ* stock and paid by *A*'s estate is $40. *B* dies two years after *A*, and the trust pays a GST tax of $50.[375] *B*'s estate will not receive a credit for previously taxed property because her discretionary beneficial interests in the trust are not susceptible to valuation. The trust will not receive a credit for previously taxed property because IRC § 2013 provides a credit only to reduce the estate tax.

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[372] Treas. Reg. § 20.2013-1(a).
[373] *Id*.
[374] IRC § 2035(b) applies to include the amount of gift taxes paid by *A* in *A*'s gross estate because *A* made the gift within three years of her death, but the stock itself is not included in *A*'s gross estate.
[375] For further discussion of the GST tax, see *infra* § 27.

> *Example 5: The recipient possesses a testamentary general power of appointment over assets held in trust.* The facts are the same as in example 4, except that *B* has a testamentary general power of appointment over the trust corpus, which *B* does not exercise. At *B*'s death, IRC § 2041(a)(2) includes the corpus of the trust in *B*'s gross estate. *B*'s estate will receive a credit for previously taxed property.[376]

The IRC § 2013 credit is more complicated than the preceding examples suggest. IRC § 2013 requires a determination of the value of the transferred property as well as the tax attributable to the transferred property in each of two estates. The determinations of the estate tax attributable to the transferred property can be complex, because of deductions, exclusions, and credits for both of the estates.

The credit for previously taxed property is premised on the notion that it is inappropriate to impose the estate tax on property more than once in a short period of time. The credit works reasonably well in the context of multiple transfers at death when all of the transfers are subject to the estate tax. As examples 3 and 4 demonstrate, however, IRC § 2013 does not ameliorate the impact of multiple transfer taxes that are imposed in close order if either the transfer by the transferor or the subsequent transfer by the recipient is subject to the gift or the GST tax, rather than the estate tax. Under IRC § 2013, no credit is available to a recipient's estate for a transfer of property subject to the gift tax when the recipient dies soon after the transferor made the gift. Similarly, no credit is available if the recipient's death results in a GST tax, rather than an estate tax.[377]

Alternatives

1. <u>Expand the Credit for Previously Taxed Property to Include Gift and GST Taxes</u>. 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.[378] Potential abuse may arise if Congress were to make the credit available for a subsequent transfer that does not occur as a result of death, such as when a recipient makes a subsequent gift or a trustee makes a taxable distribution under the GST tax law. 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.

An expansion of the availability of the previously taxed property credit is consistent with IRC § 2013's purpose of preventing the depletion of property by the imposition of multiple transfer taxes during a short period of time. In addition, the expansion of the previously taxed property credit is consistent with Congress's adoption in 1976 of the unified wealth transfer tax

[376] The death of *B* does not result in a taxable transfer under the GST tax law because the transfer is subject to the estate tax. Treas. Reg. § 26.2612-1(b)(1)(i).

[377] For further discussion of previously taxed property in the context of the GST tax, see *infra* § 27.B.

[378] Congress also may want to consider tax avoidance possibilities that arise because the estate tax is tax inclusive and the gift tax is tax exclusive. For further discussion of tax inclusivity and tax exclusivity, see *infra* § 20.

system.[379] Expansion of the previously taxed property credit has the further advantage of removing the current premium on sophisticated estate planning techniques that may not be widely known. Moreover, expansion of the credit removes the incentive for individuals to make dispositions they might not otherwise make to minimize taxes. For example, a testator may use a formula clause in a trust to grant a general power of appointment to a child to the extent necessary to minimize combined estate and GST taxes at the child's death, after taking into account any available previously taxed property credit.

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. This alternative would not require tracing the actual income paid. Rather, the regulations could continue to rely on a presumed rate of return. The advantage of this alternative is that it prevents an overvaluation of the property based on the recipient's life expectancy, because it values the property by taking into account when the recipient actually died.[380]

3. Repeal the Previously Taxed Property Credit. Congress could repeal IRC § 2013 and not provide a credit for previously taxed property. The complications of the credit, especially if it were to apply also to gift and GST taxes, may warrant its repeal. Provisions deferring tax payments may provide taxpayers sufficient opportunity to arrange for the orderly disposition of assets for the payment of taxes and, thereby, reduce the hardship that may arise because of the imposition of multiple transfer taxes within a relatively short period of time.

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.[381] Congress could use the GST tax definition of a transferor,[382] and could determine generation assignments by reference to the GST tax, which assigns trusts as well as individuals to generations.[383] A transfer to a younger generation would not give rise to a credit, even if the transfer took place shortly after another transfer that was subject to tax. This proposal abandons the principle of the estate tax law that is reflected in the previously taxed property credit, namely, that two estate taxes should not have to be paid on the same property within a relatively short period of time. Instead, it builds on the structure of the GST tax law, which focuses on intergenerational transfers, by preventing a transfer tax on

[379] Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976).

[380] Congress also could reconsider why the estate tax attributable to the transferred property in the transferor's estate is based on an average rate of tax while the estate tax attributable to the transferred property in the recipient's estate is based on a marginal rate of tax. IRC § 2013(b), (c); Treas. Reg. § 20.2013-2, -3.

[381] The credit would apply regardless of whether the transfer gave rise to an estate, gift, or GST tax. The scheduled reduction in the credit found in IRC § 2013(a) would be inapplicable to this credit, which focuses on multiple transfers within a generation, rather than multiple transfers within a relatively short amount of time.

[382] IRC § 2652(a).

[383] IRC § 2651.

property more than once in a generation. 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.[384]

§ 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.

Current Law. IRC §§ 2036, 2037, and 2038, the so-called string provisions, make some lifetime transfers that are subject to the gift tax also subject to the estate tax. The wealth transfer tax system regards those lifetime transfers as sufficiently complete to constitute taxable gifts, but not sufficiently complete to avoid inclusion in the gross estate of a decedent for estate tax purposes.[385] The purpose of the estate tax string provisions is not to tax the same transfer twice. IRC § 2001(b) precludes double taxation.[386] The string provisions also are not intended to eliminate the advantages of lifetime transfers, such as computation of the gift tax on a tax exclusive tax base.[387]

If Congress had intended to eliminate the tax benefits of gifts it could have done so directly, rather than by only negating the benefits of lifetime transfers covered by the string provisions. Three explanations arguably justify the string provisions. One is that Congress simply believes transfers that appear testamentary in nature ought to be subject to estate taxation. A second is that enjoyment or control of an asset previously subject to the gift tax is itself a

[384] For further discussion of tax inclusivity and tax exclusivity, see *supra* § 20.

[385] The literature refers to a wealth transfer tax rule that treats a lifetime transfer as complete and taxable for gift tax purposes, but not sufficiently complete to avoid estate taxation, as a "hard-to-complete" rule. *See* Joseph Dodge, *Redoing the Estate and Gift Taxes Along Easy-to-Value Lines*, 43 TAX L. REV. 241 (1988).

[386] IRC § 2001(b) can apply to allow a taxpayer to incur too little tax, and sometimes a taxpayer is disadvantaged by payment of tax during life and again at death. Even when the statute works properly, it adds a level of complexity. The reason it works to a taxpayer's advantage is because it may purge the full value of a lifetime transfer that is brought back into a decedent's gross estate, even though a portion of the lifetime gift was to a third party and should remain taxable without adjustment. For example, if taxpayer *A* created a lifetime trust to pay income to *X*, then income to the taxpayer, and the remainder to *Y*, that trust would be included in *A*'s estate under IRC § 2036(a)(1) in an amount equal to the fair market value of the trust assets, reduced by the value of the life estate to *X*. But, under IRC § 2001(b), the adjustment would eliminate the full value of the lifetime transfer. An adjustment that excluded only the value of the secondary life estate retained by *A* and the value of the remainder that follows it would correspond to the amount included in *A*'s estate.

IRC § 2001(b) can work to the disadvantage of taxpayers because the offset for gift tax payable under IRC § 2001(b)(2) does not reflect the time value of money. It does not take into account the fact that the government has use of taxpayers' money during the period of time between when taxpayers make lifetime gifts and when they die. Taxpayers, therefore, are less well off than if they had not made the lifetime gifts and had made the transfers at death.

[387] For further discussion of the tax exclusivity of the gift tax and tax inclusivity of the estate tax, see *supra* § 20.

reason for taxing that asset at death under the estate tax. These first two reasons are really only one explanation, because being testamentary is a function of retained enjoyment or control. The third explanation is that an estate tax on property previously subject to the gift tax results in the taxation of any appreciation of that property that occurs between the time the taxpayer makes the gift and the time the taxpayer dies.

The explanation that the transfers are testamentary in nature is a reflection of a time when disappointed heirs challenged the validity of certain lifetime transfers on the basis that they *ought* to be subject to the formalities required for a valid will. The string provisions seem to echo that general sense—that the estate tax should apply to assets that the decedent had retained enjoyment of or control over during life. State law has come a long way toward assuring the validity of lifetime transfers, regardless of their testamentary appearance.[388] This widespread recognition under state laws would seem to weaken the criterion of testamentary in nature as a rationale for justifying the string provisions.

The second explanation for the string provisions is a concern about the retention of enjoyment of or control over assets that previously were subject to gift taxation. One aspect of this concern may be that the gift tax is inadequate. That would not be an issue if the estate and gift tax rates are the same and the gift tax is imposed on the entire value of the property transferred.[389] A tax on the entire value of the property would mean that the law ignores a taxpayer's retention of or control over an income interest or other interest when valuing an asset for gift tax purposes, and prevents the taxpayer from taking advantage of the inadequacies of valuing temporal interests.[390]

Another aspect of this second concern may be that a taxpayer who enjoys the use of or control over transferred property for life ought to incur estate tax on the benefits attributable to that use or control. That raises the question of whether taxation during life on the full value of the property when transferred plus estate taxation on the fruits of any retained enjoyment or control fails to extract the proper amount of tax from a taxpayer who continues to use or control the property until death.

In this regard, consider a taxpayer who transfers an asset worth $100 and incurs a gift tax on that $100. That gift tax is imposed on both the right to receive future income from the underlying asset and the right to do whatever the owner wishes with the asset itself. If the taxpayer continues to receive income from that asset, that added income will increase the taxpayer's net worth and it *also* incurs tax—presumably in the form of an estate tax on the taxpayer's increased net worth at death. The gift tax already subjected the corpus to taxation, and the estate tax subjects the added income that the taxpayer retained to taxation. Therefore, the benefit of having retained the enjoyment itself does not escape wealth transfer taxation.[391]

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[388] See Article 6 of the Uniform Probate Code, which validates nonprobate transfers, and Part 7 of Article 2 of the Uniform Probate Code, which applies a variety of construction rules to nontestamentary and testamentary governing documents.

[389] For further discussion of the difference between the tax inclusivity of the estate tax and the tax exclusivity of the gift tax, see *supra* § 20.

[390] For further discussion of valuation of temporal interests, see *supra* § 18.B.

[391] There are situations that may escape taxation. They would involve circumstances in which the taxpayer retains enjoyment of non-income-producing property, such as a principal personal residence or artwork. Living in the home,

If the taxpayer does not retain enjoyment of the transferred asset but, instead, retains control over that asset, the benefits of retained control do not increase the taxpayer's net worth at death in the same way that retaining income from the transferred asset does. The retention of control raises difficult questions for a wealth transfer tax system, including: What is the value of retaining control over someone else's enjoyment of property? Is that value a proper subject for wealth transfer taxation? Is the value of that control taxed at the time a gift tax is imposed on the transfer of the underlying asset? The primary problem with taxing retained control of transferred property is that it does not benefit the transferor economically.[392]

Wealth has only two benefits. One is to consume it for personal enjoyment. The other is to control another person's enjoyment of it. After both the income generating and control elements of an asset have been taxed, subsequent taxation by reason of the taxpayer's continuing control may not be necessary. Although a transfer may look to be testamentary, because it does not seem like anything substantive changed before and after the transfer, as this discussion previously suggested, changes in state law have weakened that rationale for justifying the string provisions.[393]

The third explanation for assuring taxation of appreciation of assets also is problematic. A fundamental assumption about tax planning seems to underlie this concern about taxing appreciation. This assumption is that lifetime transfers are the product of strategic planning that carefully identifies the growth potential of an asset and seeks to minimize taxes by incurring tax at today's value rather than at an appreciated value at death. That is, the assumption is that taxpayers select assets for lifetime giving for the purpose of minimizing wealth transfer taxation through "estate freezing," i.e., avoiding wealth transfer taxation on future appreciation. Even if the string provisions were to apply solely to assets that appreciate in value, or solely to assets that *could* appreciate in value, concern about tax avoidance through estate freezing would make sense only in an environment in which assets appreciate in value *and* the tax rates are progressive. Estate freezing does not undermine the integrity of the wealth transfer tax system without higher tax rates on greater amounts of value, which means that, in the new environment of nearly flat tax rates, the string provisions lose their relevance. This relationship of estate freezing to progressive tax rates relies on relatively recent developments and requires more explanation.

The estate freezing concern assumes that a taxpayer can save more money by paying a tax (say, at a 40 percent rate) on $100 today than by paying a higher tax (say at a 50 percent rate)

in fact, *does* produce a benefit that will be taxed, in the form of rent that was not paid to live elsewhere. But retaining the visual enjoyment of artwork leaves no residual net worth increase the way rent avoidance or income received would. In a sense, enjoyment of artwork is more like the retention of control, which also does not increase the taxpayer's net worth at death. The text immediately following discusses the treatment of retained control over previously transferred property.

[392] Consideration of the "reasonably definite external standard" exception to the string provisions illustrates the ambivalence of the estate tax law regarding retained control. See 2 JAMES CASNER & JEFFREY PENNELL, ESTATE PLANNING § 73.3 nn.55–57 and accompanying text (6th ed. 1999); Dodge, *supra* note 385, at 313–14. Courts created this exception, which mirrors the "ascertainable standard" exception legislatively embraced in IRC § 2041(b)(1)(A), having to do with powers of appointment. The fact that courts treat trustee powers or other powers, if properly "constrained," as beyond the scope of the string provisions indicates that "control" is a problematic concept that requires difficult line drawing.

[393] *See supra* text following note 388.

on $200 at some future date, such as at death.[394] One problem with retaining the string provisions because of a concern about estate freezing is that it ignores the possibility that asset values also can depreciate. This is true even for those assets that taxpayers carefully select as having the greatest likelihood of increasing in value. The late twentieth century technology "bubble" in the stock market illustrates the difficulties taxpayers face in trying to select assets strategically. Furthermore, today, progressivity in tax rates is modest and declining. Under the EGTRRA, progressivity disappears from the rate table after 2006, when the estate tax applicable exclusion amount increases to $2 million and the highest marginal wealth transfer tax rate drops to 46 percent, which also applies at the $2 million threshold.[395] A discussion of the underlying rationales for the string provisions becomes more compelling in a legal and political environment in which the transfer tax becomes flat after 2005. As the example below demonstrates, it does not matter whether the tax is imposed on an asset at today's lower value or at tomorrow's appreciated value in a flat tax environment.[396]

> *Example: An asset is subject to a transfer tax at different times.* *G* owns an asset worth $100 at time 1. It will be worth $200 at time 2. *G* wants to transfer the asset to *B*. *G* could make a gift of the asset to *B* at time 1 and pay a tax, or *G* could defer the transfer to *B* until time 2. The question is whether the timing of *G*'s gift affects the amount of property *B* owns at time 2. In a 50 percent flat tax environment, *G* can transfer $66.67 of the asset to *B* at time 1 and pay a tax of $33.33 with the remaining value of the asset. At time 2, the gift to *B* of $66.67 would be worth double that amount, or $133.33. Alternatively, *G* can retain the asset until time 2, when it would be worth $200. At time 2, *G* then can transfer $133.33 of the asset to *B* and pay a 50 percent tax of $66.67 with the remaining value of the asset. Under either planning strategy, at time 2, *B* owns an interest in the asset worth $133.33. *G* gains no advantage from either early *or* deferred taxation. Neither the taxpayer nor the government benefits as a result of when a transfer tax is imposed.[397]

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[394] For the purpose of this discussion, the income tax benefit of the step-up in basis rule of IRC § 1014, which is available only for property included in a decedent's estate, is ignored for ease of exposition.

[395] IRC §§ 2001, 2010, 2505.

[396] Congress could address other factors making lifetime transfers advantageous, such as a generous annual exclusion, the valuation rules, or a tax exclusive tax base. For further discussion of each of these gift tax issues, see respectively *supra* §§ 16, 18, and 20.

[397] The example eliminates the tax inclusivity/tax exclusivity distinction between the estate and gift taxes. For further discussion of that issue, see *supra* § 20. As an aside, there are several reasons why incurring wealth transfer tax at time 1 may be desirable, but they have nothing to do with either the string provisions or avoiding tax at death on appreciation. One advantage would be paying the tax on the lifetime transfer with assets other than those that will double in value. For example, the unified credit is more valuable at time 1 than at time 2, because it does not have the opportunity to appreciate in value. Although closely related to the issue of taxing appreciation, *G*'s advantage is not in subjecting the $100 to taxation before it grows to $200, but rather it is in paying the tax with $33.33 that will not be worth $66.67 later. That advantage arises because the unified credit does not grow in value. The sooner a taxpayer uses it, the better.

The U.S. government probably does not want to be paid in kind with assets that may appreciate in value, but it should not be lost on this discussion that: (i) this is a different issue than freezing the value of the transferred asset, and (ii) the government can take the tax payment and put the money to work in ways that mimic the benefits of appreciation. That is, the government could use the $33.33 of tax payment at time 1 to generate its own growth to $66.67 of value by time 2. Waiting to be paid at time 2 is not essential to the government's benefiting from growth in valuation between time 1 and time 2.

It probably is appropriate to question whether the string provisions are necessary even in a world in which assets only appreciate in value and the tax rates are and will remain progressive. The question is whether there is merit in taxing appreciation at death. One answer is that any increase in value does not benefit a taxpayer who has already transferred ownership of an asset. That is, retaining the enjoyment of income from the asset does not permit the taxpayer to enjoy the increased underlying value of the corpus. Nor, arguably, does retention of control over enjoyment of the asset by another person give the taxpayer different benefits, whether the underlying property is worth more or less at death.

In addition, the government has its own opportunity to invest, reinvest, and earn income, or to generate growth on its share of the taxpayer's wealth if gift tax is paid on a lifetime transfer. Whatever benefit the taxpayer may enjoy attributable to appreciation in the underlying property would seem to be offset by the benefit the government enjoys by having received tax dollars earlier than it would have had the taxpayer never made a taxable lifetime transfer. The government's investment opportunity is pertinent to the question of whether the government should tax appreciation on an asset that occurs between the time of the lifetime transfer and the taxpayer's death. Neither the taxpayer nor the government seems to gain an advantage by a taxpayer's being taxed sooner rather than later, which means that taxing appreciation also appears to be a weak rationale for the string provisions.

If the benefit to the taxpayer of avoiding tax on appreciation is offset by the benefit to the government of the taxpayer's early payment, the question about whether the string provisions are necessary becomes how would the transfer tax system be undermined if, for example, the taxpayer makes a lifetime transfer into a trust, pays gift tax on the full value of the property transferred, retains lifetime enjoyment of the income from the trust, and controls the investment and other people's enjoyment of the trust corpus without incurring any further estate tax at death. Imagine if a taxpayer like Sam Walton or Bill Gates had taken a share of his wealth in the form of stock in his ultimately, wildly successful (but then budding) corporation and had made a transfer into a trust, paid gift tax on that amount, and then invested the smaller amount that remained in his trust to build Wal-Mart and Microsoft, respectively. The value of the transferred property in each of the trusts at their deaths would be worth a tremendous amount more than the value of the corporate stock they originally placed in trust. The government would have lost a significant amount of tax revenue if these two entrepreneurs had created trusts early in their careers. The government, however, could have used Walton's and Gates's tax payments to do its own investing. Besides, other founders of what ultimately will prove to be failed business enterprises also may make taxable lifetime transfers and end up paying more in gift tax than they otherwise would have incurred in estate tax at death. Viewed in this light, the opportunity for estate freezing does not appear to support continuance of the string provisions and the complications that accompany them.

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. This approach would avoid valuation of temporal interests.[398] It also would eliminate the need for the provision in IRC § 2001(b), which prevents double taxation of a transfer. One problem with this alternative, however, is that it would seem difficult for Congress to justify changing these well-known, though complex, rules if payment of tax sooner rather than later produces neither net benefit nor harm to the taxpayer or the government. Simplification is its primary justification.

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.[399] This alternative would eliminate the possibility that a transfer is taxed both during life and at death and, therefore, also would eliminate the need for the provision in IRC § 2001(b), which prevents double taxation of a transfer.[400] In the case of a taxpayer who makes a transfer to a third party without retaining *any* right to enjoyment or control, Congress could continue to treat that transfer as a taxable gift. Alternatively, if a taxpayer chooses estate tax treatment rather than gift tax treatment at the time of the transfer, subsequent distributions of either income or corpus from a trust to a person other than the transferor would be taxable as gifts at the time of distribution. In any event, the election would not apply unless the full value of the underlying asset is subject to the gift tax. Transfers involving grantor retained annuity trusts, qualified personal residence trusts, or other similar types of transfers would not be eligible, because those types of transactions permit taxpayers to reduce the value of the transferred interest.[401]

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

[398] For a discussion of valuation of temporal interests, see *supra* § 18.B.

[399] Whether a taxpayer actually incurs a gift tax liability is not relevant. The issue is whether the transfer is subject to the gift tax.

[400] This alternative would eliminate the need for the three-year rule under IRC § 2035(a)(2) for transferred assets over which the taxpayer retains enjoyment or control. A similar approach to annuities, life insurance, and jointly owned property also would eliminate the need for the three-year rule. For a discussion of these other types of transfers, see *infra* §§ 23.B and 23.C.

[401] For further discussion of the valuation of temporal interests, see *supra* § 18.B.

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.

Current Law. The analysis of the treatment of investment assets under the string provisions of IRC §§ 2036, 2037, and 2038 applies equally well to contractual arrangements, such as annuities or life insurance.[402] Under IRC § 2039(a), a decedent's estate is taxed on "the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent."[403] An annuity is subject to the estate tax only if the decedent had the right to payment "for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death." The three statutory periods designated in IRC § 2039(a) are the same as those found in IRC § 2036. Indeed, IRC § 2039 generally mirrors IRC § 2036, which makes the earlier discussion of IRC § 2036 pertinent. For the reasons suggested in that earlier discussion, if a taxpayer otherwise made a taxable transfer of an annuity during life, the rationales are weak for imposing a tax on the annuity contract at the taxpayer's death because the taxpayer had retained the right to receive payments until death or had retained any other interest in or control over the annuity contract. A taxable transfer could include either the taxpayer's designating a beneficiary or transferring the annuity contract itself.

For the reasons suggested in the discussion of the string provisions, if the taxpayer otherwise made a taxable transfer of a life insurance contract during life, the rationales also are weak for imposing a tax, under IRC § 2042, on the life insurance proceeds at the taxpayer's death because the taxpayer had retained interests in or control over the life insurance contract. As in the case of an annuity, a taxable transfer of a life insurance contract could include either the taxpayer's designating a beneficiary or transferring the life insurance contract itself.

A common misunderstanding of life insurance relates to the value of the contract during the life of the insured, which is either the accumulated premium payments or the interpolated terminal reserve value of the policy. In many instances, the value of a life insurance contract is far less than the face value of the contract proceeds payable at death. Nevertheless, life insurance premium payments are like any other investment. This is particularly clear with respect to permanent insurance coverage, but it also is true for term insurance. In either case, the premium payments are held by the insurance company and invested by it to guarantee its contractual promise to pay the insured or the designated beneficiary a favorable investment return over the insured's expected life. With term insurance, the amount invested varies with the likelihood that the life expectancy is accurate, and the expected favorability of the return is an important factor for the vast majority of insured persons who decide eventually to terminate coverage before maturity of the policy.[404] With permanent insurance, it is much easier to see that investing in life

[402] *See supra* § 23.A.

[403] IRC § 2039(a) makes an exception for insurance on the life of the decedent, because those proceeds are otherwise includable under IRC § 2042.

[404] This analysis may be skewed to the extent that group term insurance allows individuals to enjoy a greater return by paying premiums at lower group rates than would apply for similar individual policies, although the insurance underwriting is designed to exact an amount of payment appropriate to the risk assumed by older or less healthy individuals who are part of the group.

insurance is no different from investing in any appreciating asset—insurance may have a better appreciation guarantee, but it also likely costs more as a result.[405]

Therefore, the estate tax should not treat insurance differently than any other asset. A taxpayer could expend $100 to acquire an insurance policy with a face value of $1,000, or could invest $100 to acquire stock or real property, the value of which may increase to $1,000 (or many multiples of $1,000) at the taxpayer's death. Either investment might yield more or less than $1,000. Life insurance can return far less than the face value of the contract because it might be allowed to lapse before the insured dies.[406] Unless somehow the insured is better at predicting the timing of death than are the insurer's medical underwriters and mortality actuaries, there is no reason to assume that premiums paid are not an accurate reflection of the discounted present value of the payments to be made by the insurer when the contract matures.[407] As illustrated in the previous discussion of the string provisions, both the government and the taxpayer may be indifferent as to whether the taxpayer pays a gift tax on the insurance premiums or the taxpayer's estate pays an estate tax on the proceeds at the taxpayer's death. This would be even more likely if the wealth transfer tax system had a flat tax rate.

Alternatives

1. <u>Allow Taxpayers to Elect Either Gift Tax or Estate Tax Treatment upon the Designation of a Beneficiary Under an Annuity Contract or Its Transfer</u>. 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.[408] The value of the taxable transfer would be the value of the annuity, determined at the time the taxpayer designates the beneficiary, irrevocably or otherwise, to receive payments under the annuity contract upon the taxpayer's death. If the taxpayer designated the beneficiary to receive annuity payments following the taxpayer's death, the value of the gift would include the value of the payments expected to be made to the taxpayer, and it also would take into account the actuarial likelihood that the taxpayer would outlive the secondary beneficiary. 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

[405] Some insurance carries no guarantee, but dependable coverage from reliable insurers actually pays on average a lower investment return than investments in common equities.

[406] If premiums were paid on a life insurance contract that was allowed to lapse before death, and if the premium payments were treated as a gift, lapse of the contract would preclude any ultimate transfer of proceeds to others, and the taxpayer would have paid gift tax unnecessarily. In that regard, the risk of loss under an immediate payment of gift tax on insurance premium payments offsets the potential that few premiums will be paid and the insured will die early, resulting in a higher than average rate of return on the investment that avoids estate taxes.

[407] If this were not true, insurance companies would be going out of business.

[408] Whether a taxpayer actually incurs a gift tax liability is not relevant. The issue is whether the transfer is subject to the gift tax.

in the taxpayer's gross estate, in accordance with IRC § 2039.[409] Congress also could permit the taxpayer to elect gift tax treatment on the value of an annuity when the taxpayer transfers the entire annuity contract to a donee. The full fair market value of the annuity would be the amount of the gift.[410]

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.[411] Gift tax treatment would be available regardless of whether a taxpayer retains any control over a life insurance policy or its proceeds. 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.

One complexity that arises with respect to life insurance is the identification of those policies that should be subject to estate tax. 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. As with any other investment, however, and as in the rule recommended for the string provisions of IRC §§ 2036, 2037, and 2038, the life insurance proceeds should not be included in the insured's gross estate at death if the insured pays the premium amounts, including premium payments imputed to the insured (such as premiums paid by the insured's employer), and elects gift tax treatment for those premium payments.[412] A portion of the proceeds should be includable if the insured elects gift tax treatment on some, but not on all, of the premiums the insured pays, or is deemed to have paid. The portion of the proceeds includable should be determined by the ratio of premiums treated as lifetime taxable transfers to the total premiums paid on the policy.[413]

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[409] If a taxpayer owned an annuity contract at death and had not made an election to pay a gift tax, the contract would be included in the taxpayer's gross estate.

[410] Presumably, the purchase price of a comparable annuity would reflect the discount for the time value of money attributable to any delay in the annuity start date.

[411] Whether a taxpayer actually incurs a gift tax liability is not relevant. The issue is whether the life insurance contract is subject to the gift tax.

[412] An adjustment may be required if the insurance proceeds are paid to an entity, such as a corporation that owns the policy; the proceeds should be subject to the estate tax only to the extent that the insured owns an interest in the entity. Insurance acquired by an entity as "key person" insurance should not be includable, however, to the extent the entity is not owned by the insured.

If an insured does not elect to pay a gift tax on the premium payments, then the proceeds of insurance would be included in the insured's gross estate under IRC § 2042, as currently enforced.

[413] The inclusion rule was set forth in *Estate of Silverman v. Commissioner*, 521 F.2d 574 (2d Cir. 1975), which involved the transfer of insurance made within three years of death. The amount includable under IRC § 2035 was limited to that portion of the proceeds that was equal to the ratio of premiums paid by the insured decedent to the total premiums paid on the policy and excluded that portion of the proceeds attributable to the premium payments that was made by the donee within three years of the insured decedent's death.

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.

Current Law. IRC § 2040 adopts two different rules to determine the amount of jointly owned property to be included in a decedent's gross estate at death.[414] The consideration-furnished rule of IRC § 2040(a) applies to jointly owned property in which the joint owners are not spouses. Under this rule the entire value of the property is included in the decedent's gross estate, except for that "part of the entire value as is attributable to the amount of the consideration . . . furnished by the other joint owner or owners."[415] IRC § 2040(b) applies to jointly owned property held exclusively by spouses. It provides that one-half of the value of the jointly owned property is included in the estate of the first spouse to die. This rule is unnecessary under the unlimited marital deduction, because any portion of the jointly owned property that is includable in the estate of the first spouse to die is deductible under IRC § 2056. As a result, whether the rule includes in the estate zero, 50 percent, or 100 percent of the jointly owned property is totally irrelevant for estate tax purposes.[416] A primary advantage of IRC § 2040(b) is that it eliminates the difficult task of tracing consideration, otherwise mandated by IRC § 2040(a).

Under, the consideration-furnished rule of IRC § 2040(a), a portion of the jointly owned property that the taxpayer previously had transferred as a completed gift for gift tax purposes can be included in a taxpayer's gross estate. The question is whether this inclusion of the previously transferred portion of the jointly owned property in the taxpayer's gross estate is necessary to maintain the integrity of the transfer tax system. The answer is no, as demonstrated by the following example.

Example: The transferor provides 100 percent of the consideration for the jointly owned property and then dies. G acquires *Blackacre* in joint tenancy with *X. G* provides the entire consideration

[414] For ease of exposition, the discussion assumes that only two persons own jointly owned property.

[415] Treas. Reg. § 20.2040-1(a)(2).

[416] The only impact of IRC § 2040(b) is on the income tax basis in the property of the surviving spouse. Under IRC § 1014, the basis will equal one-half of the property's basis determined immediately before the first spouse dies plus one-half of the property's fair market value determined at the time of the death of the first spouse. Congress could amend IRC § 1014 and provide for a step-up in basis for the entire value of the jointly owned property. Under IRC § 1014(b)(6), the entire community property interest receives a basis equal to the fair market value at the decedent's death. Under IRC § 1014, however, only one-half of the property jointly owned with the surviving spouse receives a basis equal to its fair market value at the decedent's death. Amending IRC §1014 would reduce the disparate treatment that results from the differences in the property law of the various states and would provide favorable tax treatment to married couples living in noncommunity property states, who unadvisedly hold most, if not all, of their property jointly. A disadvantage of this change would be that it may encourage married couples to hold their property jointly. Moreover, the change would not entirely eliminate the disparate treatment between married couples in the various states, because it does not affect property that is not held jointly. Nevertheless, the prevalence of jointly owned property, especially in the estates of the moderately wealthy, may make this change attractive. For further discussion of jointly owned property under IRC § 1022, see *supra* § 11.B.

for *Blackacre*. *G* has made a gift to *X* of one-half of the value of *Blackacre*.[417] Experience suggests that *G* likely does not report the gift because *G* does not realize that a gift was made.[418] On the subsequent death of *G*, the primary *practical* reason to subject more than *G*'s equal, undivided ownership interest in *Blackacre* to the estate tax is the gift tax reality that the one-half interest in *Blackacre* that *G* gave to *X* has not yet been subjected to a wealth transfer tax. That is not, however, the rationale for IRC § 2040(a), which provides that, if *G* dies first, 100 percent of the value of *Blackacre*, determined at the time of *G*'s death, would be includable in *G*'s gross estate.[419] If *G*, in fact, had reported the gift to *X*, then IRC § 2001(b) would apply to assure that the one-half interest in *Blackacre* is not taxed under both the estate tax and the gift tax, but it would accomplish this by its purge and credit rule, which essentially reverses the gift tax result. In this regard, IRC § 2040(a) operates similarly to IRC § 2036(a)(1). If *G* had transferred a remainder interest in *Blackacre* to *X* and retained an income interest in it for life, IRC § 2036(a)(1) would include the entire value of *Blackacre* in *G*'s gross estate, accompanied by a purge and credit authorized by IRC § 2001(b).[420] In the situation involving a transfer in the acquisition of jointly owned property, *G* retains neither enjoyment in nor control over the property transferred to *X*, and the value of the property transferred is easily susceptible to valuation without reliance on actuarial tables.[421] Therefore, the consideration-furnished rule of IRC § 2040(a) appears even less necessary to protect the integrity of the estate tax than does IRC § 2036(a)(1). One reason for IRC § 2040(a) is the potential for noncompliance with the gift tax upon creation, improvement, or maintenance of jointly owned property.[422]

Alternatives. Transfer tax issues do not arise if spouses jointly own the property, because of the unlimited marital deduction under IRC § 2056. The alternatives set forth below, therefore, need only to consider the tax consequences that arise when the joint tenants are not married to each other or when one or both spouses are not U.S citizens.

1. <u>Repeal IRC § 2040(a) and Apply IRC § 2040(b) to All Jointly Owned Property</u>. 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

[417] If state law regarded the joint tenancy with *X* to be revocable by *G*, there would be no gift even though *G* provided all the consideration for the jointly owned property. Treas. Reg. § 25.2511-2(c). For example, if *G* had provided all the consideration for a joint tenancy in a financial obligation, such as a bank account, state law typically provides that *G* has the right to the entire amount in the bank account and, therefore, no gift occurs when *G* creates the joint interest with *X*.

[418] In any case, no gift tax may be due because the gift qualifies for the annual exclusion under IRC § 2503(b) or because *G* may be able to apply the gift tax unified credit under IRC § 2505.

[419] If *X* dies first, IRC § 2040(a) provides that no portion of *Blackacre* is included in *X*'s gross estate because *X* did not furnish any consideration for *Blackacre*.

[420] One difference, perhaps, is that it is more likely that a gift tax was paid on a gift of a remainder interest than on a gift for the acquisition of jointly owned property.

[421] For further discussion of valuation of temporal interests, see *supra* § 18B.

If *G* and *X* in the example provide equal consideration to acquire *Blackacre*, neither has made a gift. At the death of the first joint tenant, *G* or *X*, IRC § 2040(a) would include one-half of the value of the jointly owned property in the gross estate of the first to die. The survivor would include 100 percent of *Blackacre* in the gross estate. This is not a favorable result, but it is a function of the survivorship feature of jointly owned property. IRC § 2013 may ameliorate the hardship of multiple taxation within a short period.

[422] Even in the rare case in which a donor reports a gift upon creation of a joint interest, that donor is not likely to report subsequent improvements and continuing, ongoing contributions, such as unequal contributions toward payment of property taxes or mortgage installments, which also are taxable gifts.

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.[423] At the time of the death of the first joint tenant, only one-half of the value of the jointly owned property would be includable in that decedent's gross estate. This is the share of the jointly owned property that was not subject to gift tax when the transferor created the joint tenancy, or it is the donee's share of the tenancy.[424] IRC § 2033 would assure inclusion of any increase in net worth attributable to the decedent's ongoing status as a joint owner. The donee's enjoyment of the jointly owned interest during the transferor's life is not a concern because the donee's interest would have been subject to the gift tax at the time the transferor created it. A lifetime severance of the joint tenancy would result in gift taxation only to the extent that one tenant receives more than one-half of the value of the jointly owned property. The disadvantage of this solution is that it depends on taxpayers' reporting gifts made at the time they create or contribute to jointly owned interests.

2. <u>Repeal IRC § 2040 and Treat 100 Percent of the Value of the Jointly Owned Property as a Taxable Transfer Under the Gift Tax Law</u>. 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. This is appropriate because that decedent was taxed during life on the full value of the transfer. The donee's enjoyment of the jointly owned interest during the transferor's life is not a concern because the donee's interest would have been subject to the gift tax at the time the transferor provided the consideration to acquire, improve, or maintain the jointly owned property.

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. Presumably, the previously taxed property rule of IRC § 2013 is adequate to address situations involving multiple estate taxation within a short period of time.[425] The 100 percent inclusion in the transferor's gross estate, notwithstanding that the transferor earlier had paid gift tax on one-half of the value of the transferor's contribution to the joint tenancy and that the donee included 50 percent of the value of the joint tenancy in the donee's gross estate upon the donee's death before the transferor's subsequent death, is a function of the survivorship feature of jointly owned

[423] Creation of a joint tenancy bank account or other similar financial account may not constitute a completed gift under state law until the noncontributing joint tenant makes a withdrawal of more than his or her contribution to the account.

[424] If, however, only one-half of the jointly owned property is included in the decedent's gross estate, then, under IRC § 1014, the surviving joint tenant takes a basis equal to one-half of the asset's fair market value and continues to have a basis in the other half determined under IRC § 1015.

[425] For further discussion of an expansion of the scope of IRC § 2013, see *supra* § 22.

property.[426] Severance of a joint tenancy while both joint tenants are alive would result in gift taxation only to the extent that one tenant receives more than one-half of the value of the jointly owned property. The disadvantage of this solution is that it depends on taxpayers' reporting gifts made at the time they create, improve, maintain, or terminate jointly owned interests.

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. IRC § 2033 would assure inclusion of any increase in net worth attributable to the transferor's ongoing status as a joint owner and would subject the entire value of the property to tax at the survivor's death. 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.[427] This solution is problematic because of the likely noncompliance with the gift tax law.

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. The benefit is that the transferor would not be subject to an ongoing gift tax each year that the donee receives enjoyment of the property during the transferor's life.

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. It could adopt a similar rule for subsequent improvements or contributions to the jointly owned property. 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. The disadvantage of this approach is that the donee joint tenant receives enjoyment of the property before the transferor joint tenant incurs a transfer tax. The cure would be annual gift

[426] If the joint owners are married to each other, the marital deduction would ameliorate these tax consequences. In many other cases, the unified credit applicable exclusion amount may ameliorate the tax consequences for both the transferor's estate and the donee's estate. Therefore, any untoward results are likely to affect only relatively wealthy, unmarried taxpayers who have not had the benefit of estate planning advice.

[427] The availability of the annual exclusion under IRC § 2503(b) may, in many cases, make noncompliance with a rule recognizing annual gifts less of a problem.

taxation of the donee's annual enjoyment, which is problematic because of likely noncompliance with the gift tax law.

§ 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.

Current Law. Several estate tax provisions address liquidity concerns. IRC § 6161 allows a limited extension of time to pay the estate tax for reasonable cause. IRC § 6163 allows an extension of time for the payment of the estate tax attributable to the value of reversionary or remainder interests in property. IRC § 6166 allows for an extension of time for the payment of the estate tax attributable to the value of a closely held business, but the time extension is available only if the value of the closely held business is significant relative to the value of the entire estate.[428] The estate tax does not provide a relief provision for annuities includable under IRC § 2039.

With few exceptions, IRC § 2039 applies to include the value of "an annuity or other payment receivable by any beneficiary by reason of surviving the decedent" in a decedent's gross estate. The annuity is taxable to the extent that the value of the annuity or other payment is attributable to contributions made by the decedent or by the decedent's employer.[429] The term "annuity or other payment" as used with respect to either the decedent or the beneficiary refers to one or more payments extending over a period of time.[430] "The payments may be equal or unequal, conditional or unconditional, periodic or sporadic."[431] An annuity or other payment "includes any arrangement, understanding, or plan . . . arising by reason of the decedent's employment."[432] An annuity "'was payable' to the decedent if, at the time of his death, the decedent was in fact receiving an annuity" and the "decedent 'possessed the right to receive' an annuity . . . if, immediately before his death, the decedent had an enforceable right to receive payments at some time in the future," regardless of whether the decedent "had a present right to receive payments" at the time of death.[433] Accordingly, the amount includable in a decedent's gross estate is the value at the decedent's death of the annuity or other payment receivable by a survivor. It does not matter whether the annuity is payable in a lump sum or in installments. A problem arises because the incidence of the estate tax on an annuity frequently does not coincide with the receipt of the annuity payments. A hardship for the annuitant or the estate can arise in the case of an annuity that is payable over time, because the estate tax attributable to the annuity is payable at the decedent's death and the decedent's estate may not have other liquid assets sufficient to pay the tax.

[428] For further discussion of tax deferral under IRC § 6161, see *infra* § 25.
[429] IRC § 2039(b).
[430] Treas. Reg. § 20.2039-1(b)(1).
[431] *Id*.
[432] *Id*.
[433] *Id*.

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. IRC § 2056A(e) grants Treasury regulatory authority to treat an annuity as a qualified domestic trust (QDOT). Property placed in a QDOT on behalf of a non-U.S.-citizen spouse is eligible for a marital deduction.[434]

Treasury and the IRS have crafted a system that provides maximum flexibility to qualify annuities and similar arrangements for the marital deduction. Property passing under a plan, annuity, or other similar arrangement qualifies as a QDOT if the requirements of the so-called pay-as-you-go option are satisfied.[435] The pay-as-you-go option for payment of taxes on annuities in the case of non-U.S.-citizen surviving spouses could serve as a useful model for granting relief to all annuitants under IRC § 2039. It would apply an approach already in place in the estate tax law that, with adaptations, would fully protect the tax payments due under IRC § 2039, while relieving annuitants and estates of the hardship brought about when payment of the estate tax is due before annuitants receive the annuity payments.[436]

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.

[434] IRC § 2056(d)(2).
[435] Treas. Reg. § 20.2056A-4(c)(1), (2).
[436] The pay-as-you-go option requires a surviving spouse to pay an estate tax, on an annual basis, on the corpus portion of each payment that the surviving spouse receives from the annuity or arrangement. Treas. Reg. § 20.2056A-4(c)(2). The amount of the estate tax attributable to the corpus is determined under IRC § 2056A(b) and Treas. Reg. § 20.2056A-4(c)(4). Among other things, the requirements for this option are satisfied if the noncitizen surviving spouse agrees to pay the estate tax due on the corpus portion of each annuity or other payment received under the plan or arrangement and the executor files with the estate tax return an "Agreement to Pay Section 2056A Estate Tax," which the surviving spouse must sign. Treas. Reg. § 20.2056A-4(c)(6)(ii). The estate tax under the pay-as-you-go option generally is payable on an annual basis and must be accompanied by Form 706-QDT. Treas. Reg. § 20.2056A-4(c)(6)(i). Payments commence "in the calendar year following the calendar year of the receipt by the surviving spouse of the spouse's first annuity payment." *Id.* Failure either to file Form 706-QDT or to pay the tax imposed on the corpus portion of any annuity payment in a timely manner may cause the surviving spouse to immediately become liable to pay the estate tax "on the entire remaining present value of the annuity." Treas. Reg. § 20.2056A-4(c)(6)(ii). Under the terms of the Agreement to Pay Section 2056A Estate Tax, the regulations provide that the surviving spouse may make an application for relief under Treas. Reg. § 301.9100-1. *Id.*

Current Law. IRC §6166 was added in 1958 to provide relief to estates owning significant interests in closely held businesses and required to pay estate tax.[437] Although Congress has modified IRC § 6166 many times, the statute consistently has permitted a deferral of estate tax for estates with certain characteristics that Congress has deemed determinative for identifying likely illiquidity. The deferral is available for the estate tax attributable to a qualifying estate's illiquid assets, with interest charged at a generally favorable rate.[438] For qualifying estates, IRC § 6166(a) authorizes an executor to elect to defer payment of federal estate tax attributable to a closely held business for up to five years, and then to pay the tax in up to ten equal, annual installments.[439]

To qualify for IRC § 6166 deferral, an estate must have one or more closely held businesses that have a value equal to at least 35 percent of the adjusted gross estate.[440] This ownership requirement commonly is referred to as the "35 percent test." In general, a closely held business must be an active business (e.g., a manufacturing business, a working farm, or an active real estate business), with a limited number of partners or shareholders or with a substantial ownership interest held by the decedent.[441] There are special rules for determining whether the value of a closely held business must be reduced by the value of passive assets in the active business.[442] Conversely, there are special rules for looking through inactive holding companies to their active business assets.[443] There also are special rules for certain types of businesses, such as lending companies.[444] Rules for determining the adjusted gross estate require consideration of certain transfers within three years of death.[445] IRC § 6166 supplements its qualification rules with provisions relating to acceleration of the tax payments upon a disposition of a substantial portion of the business (except for specified purposes), certain accumulations of income in the estate, or a failure to make required payments.[446]

For an estate that elects deferral under IRC § 6166, the interest rate applicable to the unpaid tax is 45 percent of the federal tax underpayment rate that applies to individuals; that rate is reduced to 2 percent on the tax attributable to the first $1,140,000 (as indexed for inflation in 2004) in excess of the applicable exclusion amount.[447] The interest is not deductible for either estate tax or income tax purposes.[448] There are special lien provisions that apply to estates electing deferral under IRC § 6166, as well as an extended statute of limitation.[449]

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[437] H.R. REP. NO. 85-2198, at 6–7 (1958) (discussing IRC § 6166, enacted by the Technical Amendments Act of 1958, Pub. L. No. 85-866, § 206, 72 Stat. 1640).
[438] IRC §§ 6166(a), (f), 6601.
[439] IRC § 6166(a)(1)–(3). The election can apply to the estate tax shown as due on the estate tax return, as well as to deficiencies. IRC § 6166(e), (h).
[440] IRC § 6166(a)(1).
[441] IRC § 6166(b).
[442] IRC § 6166(b)(9).
[443] IRC § 6166(b)(8).
[444] IRC § 6166(b)(10).
[445] IRC § 2035(c)(2).
[446] IRC § 6166(g).
[447] IRC § 6601(j).
[448] IRC § 163(h)(2)(E).
[449] IRC §§ 2204(c) (lien), 6324A (lien), 6503(d) (statute of limitation extension).

The purpose of IRC § 6166 is to minimize liquidity pressures caused by the estate tax on the estates of decedents who owned interests in closely held businesses. Implicit in this purpose is the supposition that closely held businesses are necessarily illiquid and, conversely, that passive investments are liquid. Although each supposition may be largely correct, neither is completely accurate. There are active, closely held businesses that can generate cash to pay estate tax, without the need for the estate to sell property at an artificially low value, as well as passive investments that an estate cannot readily liquidate, such as agricultural land that a decedent was not actively farming at death.

Over time, IRC § 6166 has required modification to correct both for its overinclusiveness in giving deferral benefits for business interests that are not illiquid and its underinclusiveness in failing to give deferral for illiquid enterprises. For example, one change eliminated deferral with respect to certain passive assets held in an active business, and another change added holding companies with active business subsidiaries to the group of potentially qualifying businesses.[450] Even if IRC § 6166 generally does provide the deferral benefit to the appropriate class of estates, difficulties that the government and taxpayers have encountered in its application suggest that IRC § 6166 may not be the best response to the problem of illiquidity.

For example, one difficulty is that the qualification provisions of IRC § 6166 are complex and subjective. This makes it hard for taxpayers to plan for estate tax liquidity needs, because taxpayers often cannot know, with any degree of certainty, whether an estate will qualify for deferral under IRC § 6166. Not only does uncertainty about qualification prevail during the business owner's lifetime, but unpredictability continues even after the business owner's death. Moreover, it can be several years between when an estate claims entitlement to deferral under IRC § 6166 and the IRS audits the estate tax return and challenges whether the estate qualifies. During that period, an executor takes a risk to assume deferral is available, because the IRS may later notify the estate that the estate fails to qualify.[451]

The benefits that deferral under IRC § 6166 accords to estates significantly diminish if business owners and their estates cannot rely on deferral being available. Without a certain level of confidence that their estates will qualify under IRC § 6166, business owners during life and executors during estate administration must make contingency plans in the event deferral proves unavailable.[452] The problem is not that Congress needs to make better technical changes to IRC § 6166. The problem is the nature of the statute's active business requirement itself.

A second issue concerns strategic planning and its implications for taxpayers. Business owners may alter their asset ownership before death to permit their estates to qualify for deferral under IRC § 6166. For example, a business owner may convert some liquid assets into business assets for the purpose of meeting the 35 percent test or increasing the amount of tax that the statute allows the estate to defer. Without affecting family holdings in any meaningful way, a business owner may exchange assets with family members or family trusts to qualify for deferral

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[450] IRC § 6166(b)(8), (9).

[451] Failure to pay penalties also can apply in these instances. *See* IRC § 6166(g)(3).

[452] There are numerous private letter rulings regarding the active business requirement of IRC § 6166 because the fact-specific nature of the inquiry prevents the use of a bright line test. *See, e.g.*, Rev. Rul. 75-367, 1975-2 C.B. 472; Rev. Rul. 75-366, 1975-2 C.B. 472; Rev. Rul. 75-365, 1975-2 C.B. 471; Priv. Ltr. Rul. 98-32-009 (Aug. 7, 1998).

under IRC § 6166.[453] If qualification for deferral is just a matter of planning, then the question arises why Congress should not allow all taxpayers to elect deferral under IRC § 6166.

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. The advantages of this approach are that it would eliminate the subjective qualification tests and provide deferral opportunities only to those estates that have a need for deferral. The disadvantages of this approach are that it requires retaining the statutory distinction between liquid and illiquid assets and continuing the monitoring of those illiquid assets throughout the deferral period. 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. An advantage of this approach is that it eliminates the need to distinguish between qualifying and nonqualifying estates. It also substantially shortens the deferral period. 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. This second approach corresponds to the proposal set forth in the discussion of assets transferred over which the transferor retains enjoyment or control.[454]

§ 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.

[453] IRC § 2035(c)(2) prevents a business owner from marshaling assets for these purposes by making gifts within three years of the business owner's death.
[454] *See supra* § 23.

Current Law. After 2010, IRC § 2057 allows an executor of a taxable estate to elect to deduct a portion or all of the value of a qualified family-owned business interest that is includable in a decedent's gross estate.[455] IRC § 2057(a)(3)(A) limits the deduction to $675,000. The EGTRRA repealed IRC § 2057 for decedents dying after 2003 but reinstates it for decedents dying after 2010.[456]

IRC § 2057(b), elaborated further by subsequent subsections, sets forth the requirements for an estate to be eligible to take the deduction. The estate must own an interest in a trade or business located within the United States.[457] The decedent and members of the decedent's family must own a certain percentage of the business.[458] In addition, more than 50 percent of the value of the decedent's adjusted gross estate must consist of a QFOBI, including certain gifts of a QFOBI.[459] This ownership requirement commonly is referred to as the "50 percent test." The decedent or members of the decedent's family must materially participate in the operation of the business for certain periods of time both before and after the decedent's death.[460] The business interest must pass from the decedent to members of the decedent's family or to certain employees.[461] The QFOBI cannot be disposed of for certain periods of time after the decedent's death.[462]

In operation, IRC § 2057 is complex, primarily because it applies only to circumstances involving closely held, active businesses that were family owned for a significant period of time while a decedent was alive and remain family owned for a significant period of time after the decedent died. As is the case with IRC § 6166, IRC § 2057 operates in an economically nonneutral manner because it encourages taxpayers to make one type of investment over another.[463]

Alternatives. The following modifications to IRC § 2057 address the complexity of the qualification requirements.

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. The 50 percent test is the single most complicating aspect of IRC § 2057. The purpose of this test is to limit the availability of IRC § 2057 to estates in which the QFOBI represents such a large component of the decedent's estate that liquidity is a problem. An additional requirement is that the business be nonmarketable.[464] If Congress's objective is to preserve family businesses, the requirements of illiquid or underdiversified estates may undermine that objective. For example, if a decedent had owned 100 percent of a business, but that business constituted less than 50 percent of the decedent's estate, the statute effectively concludes that the estate should use its non-QFOBI

[455] IRC § 2057(a)(1), (b)(1)(B).
[456] IRC § 2057(j); EGTRRA § 901.
[457] IRC § 2057(e)(2)(A).
[458] IRC § 2057(e)(1)(B).
[459] IRC § 2057(b)(1)(C), (3).
[460] IRC § 2057(b)(1)(D).
[461] IRC § 2057(b)(2)(B), (i)(1).
[462] IRC § 2057(f).
[463] For a discussion of IRC § 6166, see *supra* § 25.
[464] *See* IRC § 2057(e)(2).

assets to pay the estate tax attributable to the QFOBI. In practice, however, some of the decedent's heirs may not wish to incur the risks of running a closely held business after the decedent's death and would, therefore, prefer to sell the QFOBI, rather than to sacrifice liquid assets to pay the estate tax. Elimination of the 50 percent test, which then would allow for a reduction in estate tax liability, would lessen the likelihood that, in this type of situation, the estate would sell the QFOBI. At the same time that it would further Congress's objective of preserving family-owned businesses, elimination of the 50 percent test dramatically would reduce the complexity of IRC § 2057.

2. <u>Repeal the Adjustment to a Decedent's Adjusted Gross Estate for Gifts to the Decedent's Spouse</u>. 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. This adjustment reduces the likelihood that the taxpayer's estate will meet the 50 percent test, which makes it inconsistent with the general policy of the transfer tax system to favor transfers of wealth between spouses.

3. <u>Repeal the Material Participation Requirement</u>. 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. This requirement is ambiguous and adds significant complexity to the application of IRC § 2057. The statute does not define material participation, and there are no regulations or case law under IRC § 2057 to assist in resolving uncertainties about what constitutes material participation. Moreover, the related cases and other guidance under IRC § 2032A, which was the model for IRC § 2057, are not very useful, simply because the question of material participation depends heavily on the factual context of each situation. Elimination of the material participation requirement not only would reduce the statute's complexity, but would further Congress's objective of preserving family-owned businesses, as the following example demonstrates.

> *Example: An unrelated employee manages the family-owned business. G* owns 90 percent of a business, and *B* owns the remaining 10 percent. *B*, who is not a member of *G*'s family, manages the business exclusively, and neither *G* nor any of the members of *G*'s family participates in the business. *B* has been an employee of the business for less than ten years. When *G* dies, the deduction under IRC § 2057 is not available because the material participation test has not been met. The inability to qualify under IRC § 2057 increases the likelihood that *G*'s estate and *B* may have to dispose of the business to allow *G*'s estate to pay its estate tax. If Congress were to repeal the premortem material participation requirement, *G*'s estate could qualify for the deduction under IRC § 2057, thereby reducing the estate tax liability and the financial pressure to sell or restructure the business.

4. <u>Impose Interest on the Recapture Tax from the Time of the Recapture Event</u>. 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. IRC § 2057(f) imposes an

"additional estate tax" ("recapture tax") if any of a number of recapture events occur within ten years after a decedent's death.[465] The most common recapture event is disposition of a QFOBI, which may occur because the successor managers prove unqualified to make the business a success. IRC § 2057(f)(2) determines the additional estate tax by adding to the amount of estate tax savings, which the IRC § 2057 election generated, interest computed from the due date of the estate tax liability.[466] Particularly in the case of a foundering business, this interest component computed from the due date of the estate tax return can have a punitive effect. It is questionable whether the failure of a business should be a recapture event, but, if the statute treats it as one, a computation of interest from the date of the recapture event would ameliorate the potential hardship to the successor business owners. A further benefit of the modification is that it adds consistency between IRC §§ 2057 and 2032A. Under IRC § 2032A, interest on the recapture tax runs only from the date of the recapture event.[467]

5. <u>Clarify That Dispositions in the Ordinary Course of Business Are Not Recapture Events</u>. 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). The statute does not address this issue. A contrary rule regarding dispositions of inventory and the like would undermine Congress's objective of preserving family-owned businesses.

6. <u>Authorize an IRC § 2057 Election for a Partial Interest in a QFOBI</u>. Congress could modify the statute to authorize an IRC § 2057 deduction for some, but not all, of a QFOBI. Circumstances may arise in which some family members want to continue to participate in a family-owned business, while others do not. An IRC § 2057 election for only a portion of the family-owned business enhances the opportunity for continuing at least that portion of the business after the decedent's death. An election for a partial interest should not add administrative complexity. In fact, the government may find it easier to deal with fewer qualified heirs. Although the government informally has allowed partial elections on Schedule T of Form 706, the statute does not specifically authorize partial elections.

7. <u>Amend IRC § 2056(b)(9) to Allow a QFOBI to Fund a Marital Deduction Bequest</u>. 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. The basic purpose of IRC § 2056(b)(9) is to prevent an estate from claiming both a marital and a charitable deduction for the same property. That purpose could be met and an estate could use a QFOBI to fund a marital deduction bequest, if Congress were to amend IRC § 2056(b)(9) to include the following: "The value of any interest in property cannot be deducted under both Section 2055 and this Section with respect to the same decedent."

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[465] *See* IRC § 2057(f)(1).
[466] IRC § 2057(f)(2)(A)(ii).
[467] *See* Stephen E. Martin, *Drafting Estate Planning Documents for the Family Business Owner*, in ESTATE PLANNING FOR THE FAMILY BUSINESS OWNER 1293, 1307–08 (ALI-ABA 2002).

§ 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.

Current Law. Treas. Reg. § 26.2612(b)(1)(i) provides that a transfer, which otherwise qualifies as a taxable termination under the GST tax law, is not a taxable termination if it is subject to the estate or gift tax. The GST tax frequently results in a higher tax than would have resulted had the assets been subject to the estate or gift tax, primarily because the GST tax is imposed at the highest estate tax rate.[468] Transferors, therefore, adopt estate plans to avoid the GST tax, if their beneficiaries would be subject to a lower tax by having the transferred property taxed under the estate or gift tax law. For instance, a transferor may give discretion to a trustee to distribute income or corpus to a non-skip beneficiary. If the trustee distributes income or corpus to the non-skip beneficiary, that beneficiary can then make taxable gifts to donees who otherwise would be skip persons if the trustee had distributed the income or corpus to them directly. Alternatively, a transferor may give a trust beneficiary a general power of appointment to avoid a taxable termination at his or her death. In fact, it has become a fairly standard drafting technique to arrange for a "springing" general power of appointment to a beneficiary or to give an independent trustee the power to grant a beneficiary a general power of appointment solely for the purpose of avoiding a GST tax at the time of the beneficiary's death.

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. For example, a non-skip beneficiary could elect to treat a trust distribution to a skip beneficiary as a gift from the non-skip beneficiary to the skip beneficiary under the gift tax law, rather than as a taxable distribution under the GST tax law.[469] Similarly, a non-skip beneficiary's executor could elect to treat the trust assets as part of the non-skip beneficiary's gross estate and have them subject to the estate tax, rather than have the trust assets subject to the GST tax because the non-skip beneficiary's death is considered a taxable termination.[470] An election would simplify estate planning and would prevent adverse tax consequences for those taxpayers who do not have the advantage of sophisticated estate planning. If the GST tax exists only to protect the estate and gift taxes, there seems to be no policy reason not to allow taxpayers to elect estate or gift tax, instead of GST tax, treatment.

The election also has the benefit of ameliorating a GST tax that can result in a higher tax on interests held in trust than on interests held outright. Trust interests are no more valuable to a beneficiary than outright ownership. For reasons of administrative simplicity, however, the GST tax law frequently taxes transfers of interests held in trust more harshly than the estate or gift tax

[468] IRC § 2641.
[469] IRC § 2612(b).
[470] IRC § 2612(a).

law taxes successive outright transfers. The election essentially acknowledges the limitations of the GST tax law to achieve its own purposes.

One disadvantage of this alternative is that it would require that Congress develop criteria for the identification of the individual who would be eligible to elect to be treated as the transferor under the estate or gift tax law. In addition, the current unified wealth transfer tax system would seem to require statutory provisions that take an election into account when determining the tax on that individual's subsequent lifetime or deathtime transfers and subsequent elections for estate or gift tax, rather than GST tax, treatment.

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

The *General Explanation of the Tax Reform Act 1986* (hereinafter *1986 Bluebook*) states that the purpose of the federal transfer taxes is

> not only to raise revenue, but also to do so in a manner that has as nearly as possible a uniform effect. This policy is best served when transfer tax consequences do not vary widely depending on whether property is transferred outright to immediately succeeding generations or is transferred in ways that skip generations.[471]

The *1986 Bluebook* further states that the goal of the GST tax is to simplify administration "while insuring that transfers having a similar substantial effect will be subject to tax in a similar manner."[472] The legislative history of the GST tax nowhere indicates any intention on the part of Congress to tax transfers of interests held in trust more harshly than outright transfers.

In some cases, the lack of coordination between the GST tax and the estate and gift taxes may be a deliberate response to potential abuses. In other cases, the inconsistencies appear inadvertent or are the result of an intentional choice to value simplicity over uniformity. For example, the imposition of the highest estate tax rate in determining the GST tax eliminates the need to engage in a complicated inquiry into what the tax would have been had the property been subject to the estate tax.[473] In still other cases, the inconsistencies appear to arise due to

[471] STAFF OF JOINT COMM. ON TAXATION, 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 1263 (Comm. Print 1987) [hereinafter 1986 BLUEBOOK]. The Tax Reform Act of 1986 (TRA 86) enacted the current version of the GST tax. Pub. L. No. 99-154, 100 Stat. 2085.

[472] *Id.*

[473] The Tax Reform Act of 1976 first enacted the GST tax. Pub. L. No. 94-455, 90 Stat. 1520. Congress designed that tax to approximate the estate or gift tax that would have been imposed if property had been given to the oldest beneficiaries in a trust who were assigned to a generation younger than that of the grantor (referred to as the deemed transferor) and then transferred by them to beneficiaries who were assigned to even younger generations. The marginal estate or gift tax bracket of the deemed transferor was then determined to compute the GST tax. See IRC § 2602 (1976 version of the GST tax). As the 1986 BLUEBOOK indicates, Congress wanted to simplify the GST tax law adopted in 1976.

> The Congress believed, as it stated when the generation-skipping transfer tax originally was enacted in 1976, that the purpose of the three transfer taxes (gift, estate, and generation-skipping) was not only to raise revenue, but also to do so in a manner that has as nearly as possible a uniform effect. This policy is best served when transfer tax consequences do not vary widely depending on whether property is transferred outright to immediately succeeding generations or is

fundamental differences between the GST tax law and the estate and gift tax laws. Finally, several of the inconsistencies result from certain elections that the GST tax law allows the taxpayer, such as the elective allocation of GST exemption and the reverse QTIP election. These elections are intended to give the taxpayer flexibility to minimize the GST tax. Nonetheless, these elections are available only for GST tax purposes. Moreover, the increases in planning options add opportunities for tax savings at the same time that they add significant compliance costs. In sum, even if the inconsistencies are explainable on simplification or structural grounds, they nevertheless can lead to unfair results and frequently complicate the administration of the tax.

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.

Current Law. A transfer of property to a skip person, to the extent it qualifies for the gift tax annual exclusion under IRC § 2503(b), can be a nontaxable transfer for GST tax purposes. It is nontaxable, however, only if it is a direct skip made either outright or to a trust for the benefit of only one skip person during that skip person's life, and, if the trust does not terminate before that skip person dies, the assets of the trust will be includable in the gross estate of that skip person.[474] An outright transfer that qualifies for the annual exclusion under the gift tax law is exempt from taxation under the GST tax law. The problem is that the requirements for exclusion of transfers of interests held in trust under the GST tax law are more limited than the requirements for enjoying the annual exclusion under the gift tax law. The differences between the two sets of qualification rules create confusion and planning traps.

The GST tax and the gift tax laws treat transfers made in trust that are subject to withdrawal rights differently. If a transferor transfers property to a trust and gives the trust beneficiary a properly drafted right to withdraw the property transferred, the gift tax law treats the transfer to the trust as if the transferor had given the property directly to the power holder and allows the transfer to qualify for the gift tax annual exclusion.[475] In contrast, the GST tax law treats a transfer made to a trust that is subject to a right of withdrawal as a transfer to the trust and not as a transfer to the beneficiary with the withdrawal right.[476] The fact that a gift made to a

> transferred in ways that skip generations. The Congress determined that the present generation-skipping transfer tax was unduly complicated. Therefore, the Congress determined that this tax should be replaced with a simplified tax, determined at a flat rate. The Act accomplishes Congress' goal of simplified administration while ensuring that transfers having a similar substantial effect will be subject to tax in a similar manner.

1986 BLUEBOOK, *supra* 471, at 1263.

474 IRC § 2642(c). IRC § 2642(c)(1) assures nontaxability by treating the qualifying direct skips as having an inclusion ratio of zero without using any part of the transferor's GST exemption.

475 While the transfer is treated the same as if made directly to the power holder for gift tax annual exclusion purposes, it is not so treated for all estate and gift tax purposes. For example, a lapse of the withdrawal right constitutes a lapse of the general power of appointment over a trust and thus is not treated as a contribution of property by the power holder to the extent the lapse falls within the "five or five" exception of IRC §§ 2541(e) and 2041(b)(2). For further discussion of the gift tax annual exclusion and withdrawal powers, see *supra* § 16.

476 Such a transfer is a direct skip only if the trust itself is a skip person. IRC § 2612(c).

trust that qualifies for the gift tax annual exclusion does not automatically qualify for an exclusion from the GST tax causes significant confusion and complexity.[477]

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. Congress could implement this rule by providing that such transfers have an inclusion ratio of zero without requiring the transferors to allocate their GST exemptions to the transfers.[478] The advantage of this approach is that it coordinates the GST tax rule with the gift tax rule by relying on the more familiar rules of the gift tax. Most importantly, it avoids the confusion of having a transfer excluded from gift taxation, yet remain subject to GST taxation.

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. This approach also would coordinate the gift tax and GST tax rules and eliminate the potential for confusion.[479]

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.[480]

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.

[477] The rule that limits the annual exclusion for GST tax purposes is effective for transfers made to trusts after March 31, 1988. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11703(C)(1), (2), 104 Stat. 1388 (1990), amending IRC § 2642(c)(2). For transfers made before that date, if the transfer to the trust qualified for the gift tax annual exclusion, it would not be subject to the GST tax. For transfers made after that date, if the trust is not a qualified trust as described in IRC § 2642(c)(2), the GST exemption must be allocated, either by affirmative allocation or pursuant to the automatic allocation rules, to avoid the GST tax.

[478] As a corollary, the inclusion ratio of a trust that receives a transfer that qualifies for the gift tax annual exclusion could be computed (or recomputed, as the case may be) as if the GST exemption were allocated to the transfer to the trust in the amount of the transfer that qualifies for the annual exclusion, even though no such exemption, in fact, is allocated.

[479] For further discussion of the gift tax annual exclusion and a consideration of possible modifications to it, see *supra* § 16.

[480] For further discussion of the gift tax annual exclusion and a consideration of possible modifications to it, see *supra* § 16.

Current Law. The estate tax law provides for a credit to the estate of a decedent for all or part of the federal estate tax paid with respect to the transfer of property to the decedent by, or from, a person who died within ten years before or within two years after the decedent's death.[481] The GST tax law provides no relief for property previously taxed under the estate tax or gift tax law within a short period of time of the imposition of the GST tax. When the law would otherwise impose the GST tax twice, it appears to provide for limited relief in the form of an exception from the definition of a taxable transfer.[482] IRC § 2611(b)(2) excludes from the definition of a "generation-skipping transfer" a transfer that otherwise would be taxable under the GST tax law, to the extent that: (i) the property transferred previously was subject to the GST tax, (ii) the transferee in the prior transfer was assigned to the same generation as, or a lower generation than, the generation of the transferee in the present transfer, and (iii) the two transfers do not have the effect of avoiding the GST tax with respect to any transfer.

The application of IRC § 2611(b)(2) is unclear. IRC § 2653(a) provides that, if a taxable transfer occurs and immediately after that transfer the property remains held in trust, for the purpose of applying the GST tax law to subsequent transfers of that property, "the trust will be treated as if the transferor of such property were assigned to the first generation above the highest generation of any person who has an interest in such trust immediately after the transfer." This frequently is referred to as the "move-down rule."[483] Therefore, IRC § 2611(b)(2) appears not to apply to property that remains in a trust after a taxable transfer has occurred because, in any event, the transferor move-down rule would prevent the imposition of a second GST tax. It may be that IRC § 2611(b)(2) applies to property that can be traced to an earlier transfer from a trust other than the one that currently holds that property.

The lack of a credit for previously taxed property comparable to that provided for the estate tax in IRC § 2013 seems inconsistent with Congress's intent to achieve a unified wealth

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[481] IRC § 2013. For a description of this provision, a discussion of the technical problems associated with it, and a consideration of alternative approaches, see *supra* § 22.

[482] The GST tax enacted by the Tax Reform Act of 1976 contained coordinating provisions regarding the previously taxed property credit under IRC § 2013. Pub. L. No. 94-455, § 2006, 90 Stat. 1520, 1879 (current version at IRC §§ 2601–2663) [hereinafter GST Tax (1976)]. In addition, the GST Tax (1976) did not tax certain transfers that previously had been taxed, although the precise application of this provision was unclear. The GST Tax (1976) provided an exception to the GST tax for certain taxable transfers in which the property previously had been subject to GST tax, but *The General Explanation of the Tax Reform Act of 1976* contradicted the statutory language. IRC § 2613(b)(7)(B) (1976 version of the GST tax) (amended 1986); STAFF OF JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 572–73 n.11 (Comm. Print 1976) [hereinafter 1976 BLUEBOOK]. The proposed regulations under the GST Tax (1976) agreed with the *1976 Bluebook*. Prop. Treas. Reg. § 26.2613-4(b) (1976 version of the GST tax). Under either interpretation, the exclusion did not seem to work properly in some cases.

[483] For example, if a transferor places property in a trust that directs the trustee to distribute income and corpus to the transferor's lineal descendants, at the death of the last child a taxable termination occurs in accordance with IRC § 2612(a). If the trustee subsequently distributes income or corpus to the transferor's grandchildren, no taxable distribution occurs under IRC § 2612(b), because IRC § 2653(a)'s reassignment of the transferor to the first generation above the transferor's grandchildren, i.e., the children's generation, means that the grandchildren are no longer skip persons.

transfer tax system.[484] The failure to coordinate the treatment of previously taxed property results in widely different treatment for similar transfers, as demonstrated by the following example.

> *Example 1: A GST tax on property previously taxed under the estate tax law. G's* will establishes a trust for his child, *C*, for life, with a remainder to his grandchild, *GC*. *G*'s estate pays estate tax on the property that passes into the trust, and *G*'s executor allocates GST exemption to other dispositions. *C* dies one year after *G*. *C*'s death constitutes a taxable termination under IRC § 2612(a). The trust receives no credit for the estate tax paid at *G*'s death the year before.[485] In contrast, if *G* had left the same property outright to *C* and *C* had left the property outright to *GC*, *C*'s estate would have received a credit under IRC § 2013 for the estate tax paid by *G*.

The failure to take into account previously taxed property in the computation of the tax on direct skips also can lead to inequitable results. A direct skip is a transfer of property to a skip person that is subject to the estate or gift tax.[486] Its purpose is to mimic the results that would have occurred had the transferor made an outright transfer to a member of the immediately succeeding generation and had that transferee then made another outright transfer to a member of the next succeeding generation.[487] The following example demonstrates how the failure to account for the credit for previously taxed property for direct skips under IRC § 2013, when a transferor and a transferee die simultaneously, or near-simultaneously, can undermine Congress's goal of replicating the tax consequences resulting from successive outright transfers between generations.

> *Example 2: A near-simultaneous death, which results in a direct skip.* When he died, *G*, who had one child, *C*, and one grandchild, *GC*, left a will that gives $2 million *per stirpes* to those of his descendants who survive him by 100 days.[488] *G*'s executor pays an estate tax on the bequest and allocates GST exemption to other dispositions. *C* survives *G*, but dies within 100 days after *G*, and *GC*, therefore, receives the $2 million. The transfer to *GC* is a direct skip and incurs a GST tax.[489] That tax result is harsher than if *G* had not required *C* to survive 100 days. *C* would have taken the $2 million and bequeathed it to *GC*. *C*'s estate would have paid an estate tax reduced by the IRC § 2013 credit.[490]

Similarly, no credit for previously taxed property is available for GST taxes imposed twice on the same property within a short time of each other, unless the requirements of IRC § 2611(b)(2) are met. As the following example shows, disparate treatment between intergenerational outright transfers and transfers of interests held in trust arises when multiple taxable transfers occur within a short period of time.

> *Example 3: Multiple taxable transfers under the GST tax law. G* establishes a trust directing the trustee to pay income to her child, *C*, for life, and at *C*'s death to pay income to *C*'s child, *GC*, for life, and at *GC*'s death to distribute the corpus of the trust to *GC*'s child, *GGC*. *G* allocates GST exemption to other dispositions. When *C* dies a taxable termination occurs, resulting in a GST

[484] For a discussion of congressional intent in enacting the Tax Reform Act of 1986, see *supra* note 473.
[485] IRC § 2603(a)(2) provides that the trust is liable for GST tax on a taxable termination.
[486] IRC § 2612(c)(1).
[487] *See* H.R. REP. NO. 99-426, at 824 (1985).
[488] Provisions for near-simultaneous death are common. *See* UNIF. PROBATE CODE § 2-702.
[489] IRC § 2612(c).
[490] For examples showing the application of IRC § 2013, see *supra* § 22.

tax.[491] *GC* dies one year later. *GC*'s death also constitutes a taxable termination, resulting in another GST tax. The statute provides no credit for the GST tax paid when *C* died one year earlier. In contrast, if *C* had received the property outright from *G* and bequeathed it outright to *GC*, a credit for previously taxed property under IRC § 2013 would have been available upon *GC*'s subsequent death.

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. The advantage of this approach is that it eliminates the unfavorable treatment of successive interests held in trust as compared to the treatment of successive outright interests with respect to multiple taxable transfers within a short period of time. By limiting the previously taxed property credit to instances when the subsequent transfer occurs by reason of death, Congress would prevent potential abuse by those who would use taxable distributions or releases to qualify for the requirements of the previously taxed property credit. This approach assumes that Congress intends to retain the previously taxed property credit already in place under IRC § 2013.[492]

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.

Current Law. For interests created after December 31, 1976, IRC § 2518(a) provides that, if a person makes a qualified disclaimer of an interest in property, the gift tax applies to that interest "as if the interest had never been transferred to such person." IRC § 2046 refers to IRC § 2518 for the effect of a qualified disclaimer for estate tax purposes.[493] Thus, if a person makes a qualified disclaimer of an interest in property, the estate tax applies to that interest "as if the interest had never been transferred to such person."

IRC § 2518(b)(2) requires that a recipient of property disclaim within nine months of the later of the date on which the transfer creating the interest is made or the date on which the recipient attains the age of twenty-one. The "transfer creating the interest" is the date of the first taxable transfer creating the interest in the disclaimant.[494] In addition, if the property is included in the gross estate of the holder of a general power of appointment, the person to whom the

[491] IRC § 2612(a).
[492] For further discussion of the treatment of previously taxed property and alternative approaches to it, see *supra* § 22.
[493] IRC § 2518 applies to the gift tax consequences of disclaimers. IRC §2046 applies to the estate tax consequences of disclaimers. IRC § 2046 incorporates IRC § 2518 by reference and, therefore, all references are only to IRC § 2518.
[494] Treas. Reg. § 25.2518-2(c)(3).

property passes by the exercise or lapse of the general power may disclaim the interest within nine months after the exercise or lapse of the power.[495] A recipient of a remainder interest in a QTIP trust, however, must disclaim within nine months of the transfer that created the QTIP trust, rather than within nine months from the date of inclusion of the trust in the gross estate of the beneficiary spouse, under IRC § 2044.[496]

IRC § 2654(c) refers to IRC § 2518 for the effect of a qualified disclaimer for GST tax purposes. Thus, the effect of a qualified disclaimer for GST tax purposes is that the disclaimed interest is treated as if it had never been transferred to the disclaimant.[497] The disclaimed interest is considered as passing directly from the transferor to the person entitled to receive the property as a result of the disclaimer.[498] In this regard, the GST tax rules on disclaimers conform to the estate and gift tax rules. Treas. Reg. § 25.2518-2(c)(3), contrary to the general rules for taxable transfers under the estate and gift tax laws, however, does not provide a nine-month period for succeeding beneficiaries to disclaim after a taxable transfer occurs under the GST tax law.[499] The following example illustrates the disparate treatment between a disclaimer of a successive outright transfer and a disclaimer of a trust interest.

> *Example: The tax consequences of a disclaimer of a successive outright transfer and of a trust interest. G* transfers property outright to his child, *C*, who leaves the property at death to *G*'s grandchild, *GC*, who is an adult. *GC* may disclaim the property within nine months after *C*'s death. If *G*, instead, establishes a trust directing the trustee to distribute income to *C* for life and, upon *C*'s death, to distribute the corpus to *GC*, if *GC* is alive, and, if not, to *Charity X*, then *GC*, to avoid the GST tax otherwise imposed upon *C*'s death, must disclaim the remainder interest held in trust within nine months of the date that *G* establishes the trust. The imposition of a GST tax at *C*'s death does not give *GC* nine months to make a qualified disclaimer. This is true even if the interest that *G* creates on behalf of *GC* is difficult to assess. For example, if *G* gives the trustee broad discretion to invade the principal on behalf of C and gives *C* a nongeneral power to appoint the remainder interest to persons other than *GC*, the regulations nevertheless require *GC* to disclaim the remainder interest within nine months of the time that *G* establishes the trust in order to avoid the GST tax at *C*'s death.

Alternative

<u>Amend the Regulations to Permit a Beneficiary of a Future Interest Held in Trust to Make a Qualified Disclaimer After a Taxable Transfer</u>. 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. To implement this alternative, Treasury could amend Treas. Reg. § 25.2518-2(c)(3) to allow a disclaimer of all interests held in trust within nine months of a taxable transfer. The effect of this rule would be to permit a succeeding

[495] *Id.*
[496] *Id.*
[497] IRC § 2518(a); Treas. Reg. § 25.2518-1(b).
[498] Treas. Reg. § 25.2518-1(b).
[499] The legislative history of the GST Tax (1976) indicates that a taxable GST transfer starts a new nine-month period. 1976 BLUEBOOK, *supra* note 482, at 581. The final regulations under IRC § 2518, applicable to the current GST tax law, however, do not start a new nine-month period upon a taxable GST transfer. *See* Treas. Reg. § 25.2518-2(c)(3).

beneficiary to make a qualified disclaimer upon a taxable transfer under the GST tax law. It also would permit a succeeding beneficiary to make a qualified disclaimer of an interest in property held in a QTIP trust upon the death of a surviving spouse. The advantage of this rule is that it eliminates the unfavorable treatment under the disclaimer rules of successive transfers of interests held in trust as compared to successive outright transfers.

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.

Current Law. IRC § 1014(a) generally provides that the property acquired from a decedent or to have passed from a decedent takes a basis equal to the fair market value of the property at the date of the decedent's death.[500] The adjustment of basis does not depend on whether the estate incurred an estate tax liability. IRC § 1014 applies regardless of whether the value of the decedent's taxable estate is less than the applicable exclusion amount. It also applies regardless of whether the property was free from tax because the decedent transferred it in a manner that qualified for the estate tax marital deduction.

IRC § 2654(a)(2) provides that "[i]f property is transferred in a taxable termination which occurs at the same time as and as a result of the death of an individual, the basis of such property is adjusted in a manner similar to the manner provided under IRC § 1014(a)." However, it goes on to provide that "if the inclusion ratio with respect to such property is less than 1, any increase or decrease in basis is limited by multiplying the decrease or increase by the inclusion ratio." The effect of this limitation is to deny the basis adjustment for that portion of a trust attributable to the GST exemption that had been allocated to it.[501] This limitation on the basis adjustment under the GST tax law has the effect of treating successive transfers of interests held in trust more unfavorably than successive outright transfers.

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." The advantage of this rule is that it eliminates the unfavorable treatment of successive transfers of interests held in trust as compared to successive outright transfers with respect to the basis adjustments for taxable transfers occurring by reason of death.[502]

[500] IRC § 1014(b) defines what constitutes property acquired from a decedent.
[501] *See* IRC § 2642.
[502] It also would be possible to bring the basis adjustment rules under IRC § 1014 into conformity with the basis adjustment rules under IRC § 2654(a)(2) by amending IRC § 1014 to deny a basis adjustment for property that does not generate a tax. Under this approach, therefore, a basis adjustment would be denied to that portion of a decedent's

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.

Current Law. The federal estate tax law allows a state death tax credit for death taxes paid to states up to an amount set forth under IRC § 2011(b). The EGTRRA phases out the credit for state death taxes by limiting the credit. In 2005, when the credit is repealed, the Act replaces it with a deduction for state death taxes paid, which is provided in IRC § 2058.[503] If a generation-skipping transfer, other than a direct skip, occurs at the same time as, and as a result of, the death of an individual, IRC § 2604 allows a credit to reduce the federal GST tax equal to the lesser of the GST tax paid to a state or 5 percent of the GST tax. The EGTRRA repeals this provision after 2004, but does not provide for a deduction for state GST taxes comparable to the deduction for state death taxes it provides under IRC § 2058.[504] If a direct skip occurs upon the death of an individual and a state imposes a GST tax on the transfer, IRC § 2604 does not permit a credit to reduce the federal GST tax for the state tax paid.

The failure to provide either a deduction or a credit for state GST taxes makes successive transfers of interests held in trust subject to the federal GST tax more expensive than successive outright transfers. The failure to provide a credit or a deduction for state GST taxes resulting from a direct skip treats a direct skip more harshly than other types of generation-skipping transfers and more harshly than if the skip person had received the property as a result of a series of intergenerational outright transfers.

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. The advantage of providing a deduction comparable to the one found in IRC § 2058 is that it furthers Congress's goal of creating a unified wealth transfer tax system.

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. The advantage of this change is that it eliminates a distinction between direct skips and other types of generation-skipping transfers, and it furthers Congress's goal of creating a unified wealth transfer tax system.

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estate that was not taxed as a result of the unified credit as well as to any property that a surviving spouse acquired in a manner that qualified for the marital deduction.

503 For further discussion of state death taxes, see *supra* § 3.

504 IRC § 2604(c).

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.

Current Law. Under the gift tax law, a gift is complete and, therefore, subject to gift tax when a donor has relinquished "dominion and control" over the property that is the subject of the gift.[505] Treas. Reg. § 25.2511-2(d) provides that a donor has relinquished dominion and control if the donor can affect only the time and manner of the beneficiary's enjoyment of the property, but not the identity of the beneficiary. If the gift is to a trust and the donor has retained an interest in the trust that is susceptible to valuation, the value of the retained interest, which may be subject to the special valuation rules of IRC § 2702, is subtracted from the amount transferred to the trust to determine the amount of the gift.[506] The gift tax law does not consider an interest in, or power held by, a donor's spouse to be a retained interest or power for the purpose of determining whether a gift is complete and, therefore, subject to gift tax.

Under IRC §§ 2036, 2037, 2038, and 2042, if a decedent retains certain types of interests or powers with respect to property transferred during life, that property is subject to estate tax on the death of the decedent. Under IRC § 2035, if a decedent had relinquished within three years of death an interest or power with respect to property that would have been subject to estate tax under IRC §§ 2036, 2037, 2038 or 2042 had the decedent retained the interest or power until death, that property remains subject to the estate tax.[507] The estate tax law, like the gift tax law, does not consider an interest in, or power held by, a donor's spouse to be a retained interest or power for the purpose of determining whether a gift is complete.

IRC § 2642(f) limits a taxpayer's right to allocate GST exemption to a lifetime trust. An allocation of GST exemption to transferred property that would be includable in the gross estate of the transferor under any statutory section, other than IRC § 2035, if the transferor were to die immediately after the transfer, is not effective until the end of a period of time referred to as the "estate tax inclusion period" or ETIP. IRC § 2642(f) also postpones until the end of the ETIP any direct skip that otherwise would have occurred by reason of a transfer subject to an ETIP. The most common type of trust at which this limitation is aimed is the grantor retained interest trust. An example of a postponed direct skip that occasionally occurs is a transfer by grandparents to their grandchildren under the Uniform Transfer to Minors Act in which the grandparents name themselves as custodians. Any other type of generation-skipping transfer during the ETIP terminates the ETIP with respect to the generation-skipping transfer.[508] In addition, IRC § 2642(f) includes the statement that "except as provided in regulations, any reference in this subsection to an individual or a transferor shall be treated as including a reference to the spouse of such individual or transferor" (known as "the spousal rule"). The net effect of the ETIP rule is to make 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.

[505] Treas. Reg. § 25.2511-2.
[506] Treas. Reg. §§ 25.2511-1(e), .2512-5(d)(2).
[507] For further discussion of IRC § 2036, 2037, 2038, and 2042 and alternative approaches to them, see *supra* § 23.
[508] Treas. Reg. § 26.2642-4(b) (Ex. 5).

The ETIP rule is an attempt to coordinate the GST tax law with the estate tax and gift tax laws for the purpose of determining whether or when a transfer is complete for wealth transfer tax purposes. The estate tax and gift tax laws, however, are not consistent with each other, which adds to their complexity. The ETIP rule substantially increases this complexity by creating a third set of rules governing the completeness of a transfer under the GST tax law. In addition, the spousal rule included as part of the GST tax law has no counterpart in the estate tax or gift tax law.[509]

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. The gift tax rules, rather than the estate tax rules, arguably are more appropriate because they have to do with lifetime transfers. If Congress were to allow a taxpayer to elect to have a transfer treated as a taxable gift for the full value of an asset and not have that asset included in the taxpayer's gross estate at death, as is suggested in § 23 of this Report, that election could control the time during which the transferor could make an allocation of the exemption, and no special rule would be required. If Congress's concern is undue leveraging of the GST exemption by transferors who allocate it earlier rather than later, Congress could address the use of the GST exemption more directly.[510]

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). This rule is unique in the wealth transfer tax system and for that reason introduces complexity and confusion.

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.

Current Law. The GST tax consequences of a transfer or assignment of a remainder interest are unclear. They appear to depend on whether or to what extent the transfer causes a change in the identity of the transferor of the remainder interest after the assignment. The identity of the transferor is important because the transferor determines the generation assignment of the recipients of the transferred property and, therefore, the eventual GST tax consequences.[511] For reasons discussed below, the analysis of transfers of remainder interests becomes even more uncertain in the case of a sale for adequate and full consideration.

[509] At the time Congress added this spousal rule, however, there was a spousal rule that applied in certain situations for estate tax purposes under the retroactively repealed IRC § 2036(c), which itself had been added between the time Congress had enacted the GST tax and had added the ETIP rule. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11601(a), repealing Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10402(a) (enacting IRC § 2036(c)).

[510] For further discussion of the GST exemption, see *infra* § 27.C.

[511] There may be other ways to analyze the GST tax consequences of an assignment, such as focusing on whether the transferee changes for GST tax purposes. However, example 4 of Treas. Reg. § 26.2552-1(a)(5), which concerns

IRC § 2652(a)(1) provides the general rule that the donor is the transferor "in the case of any property subject to [gift tax]," and the decedent is the transferor "in the case of [estate tax]." There is no direct authority on the extent to which remainder beneficiaries who transfer all or a portion of their remainder interests held in trust in a manner that makes the transfers subject to estate or gift tax become transferors of those trusts. Similarly, there is no direct authority on the extent to which remainder beneficiaries who sell all or a portion of their remainder interests held in trust for adequate and full consideration, and therefore are not subject to estate or gift tax, become transferors of those trusts.

There are three possible ways that an assignment of a remainder interest held in trust can affect the identity of the transferor. One is that the transfer does not affect the identity of the transferor at all—that is, the transferor of the underlying property remains the same. A second possibility is that the individual assigning the remainder interest becomes the transferor of the portion of the underlying property equal to the portion of the remainder interest transferred. Yet a third possibility is that the individual assigning the remainder interest becomes the transferor of a portion of the value of the underlying property based on the relative value of the remainder interest to the full value of the underlying trust property. Under this approach, the individual becomes the transferor of a fraction of the trust, the numerator of which is the actuarial value of the remainder interest and the denominator of which is the full value of the trust property. The distinctions among these three approaches can be best understood by an example.

> *Example: A transfer of a remainder interest held in trust by the settlor's child to the settlor's grandchild.* *W* transfers $100 to a trust to pay a stated dollar amount to her husband, *H,* for *H*'s life, and on *H*'s death to pay all remaining trust property, i.e., the remainder interest, to her son, *C*, or to *C*'s estate if *C* dies before *H.* If *C* makes a lifetime gift of his remainder interest held in the trust or, if at *C*'s death before *H*, *C* bequeaths his remainder interest by will to his child, *G*, *C* then would have made a taxable transfer for estate or gift tax purposes. Under the estate and gift tax rules, the value of a remainder interest is equal to its actuarial value, unless a specific exception to the use of the actuarial tables applies.[512] If at the time *C* transfers to *G* his entire remainder interest by lifetime gift or by will the actuarial value of the remainder is, say, $15, and none of the exceptions to the use of the actuarial tables apply, *C* or *C*'s estate will be subject to estate or gift tax on that $15.

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a transfer of a term interest held in trust and is the only direct guidance on the GST tax consequences of assignments of interests held in trust, focuses exclusively on the transferor. Additional authority supporting a focus on the transferor and not the transferee is the U.S. Supreme Court's decision in Blair v. Commissioner, 300 U.S. 5, 12 (1937), which held that, for income tax purposes, the assignee of a trust interest is treated as the trust beneficiary.

[512] See Treas. Reg. §§ 20.7520-3 and 25.7520-3 for the exceptions to the use of the actuarial tables. The gift tax zero-valuation rule of IRC § 2702 (valuing the term interest at zero and then calculating the value of the remainder interest by subtracting the zero-value term interest from the total value of the trust) is one such exception, and it is cross-referenced in Treas. Reg. § 25.7520-3(a)(9). The zero-valuation rule of IRC § 2702 does not apply under certain circumstances, including when the trust in which the interest is transferred meets the definition of a "qualified personal residence trust," when the term interest in the trust is in the form of a qualified annuity or unitrust interest, or when the transferees of the transferred trust interest are nonfamily members. For further discussion of valuation of temporal interests, see *supra* § 18.B.

The preamble to the proposed IRC §§ 2701 and 2702 regulations (P.S. 92-90, 1991-1 C.B. 998) (as confirmed by the preamble to the final regulations (T.D. 8395, 1992-1 C.B. 316)) provides that IRC §§ 2701 and 2702 do not apply to the GST tax. For further discussion of the applicability of IRC §§ 2701 and 2702 to the GST tax, see *infra* § 27.B.9.

On *H*'s death, after the lifetime gift or bequest from *C* to *G*, the GST tax consequences are uncertain because the trust property passes to *G*, who is a skip person with respect to *W* but not with respect to *C*. The tax results would appear to depend on the extent to which the transferor changes from *W* to *C*. With regard to the three choices described above: (i) *W* would remain the transferor of the entire trust, (ii) *C* would become the transferor of the entire trust, or (iii) *W* would remain the transferor of 85 percent of the trust (($100 – $15) ÷ $100) with *C* becoming the transferor of the remaining 15 percent (100 percent – 85 percent), based on the relative value of the remainder interest at the time of the transfer.

For different reasons, the GST tax consequences also are uncertain if, instead of *C* making a gratuitous transfer, he sells the remainder interest to *G* for $15 when its actuarial value is $15. *G* would have paid adequate and full consideration, and the sale would not be subject to gift tax. As a result of the sale, *C* would have received the full benefit of the remainder interest held in trust that gratuitously was transferred to *C* by *W*. For that reason, it may be inappropriate for the trust potentially to be subject to the GST tax at *H*'s death, because *G* is not a beneficiary with respect to *W*, the initial transferor. Instead, *C*, as the recipient of the $15 from *G*, would seem to have remained *W*'s beneficiary.[513] Put differently, for GST tax purposes, *C* could be considered to have received a trust distribution of *C*'s entire trust interest.[514] In the case of a sale, there may be yet a fourth choice—a purchased remainder interest could simply not be subject to the GST tax at all.

The Fifth Circuit Court of Appeals decision in *Wheeler v. United States* provides support for the proposition that *C* becomes the transferor of the entire trust regardless of whether *C* transferred the remainder interest by lifetime gift, will, or sale for adequate and full consideration.[515] *Wheeler* holds that the decedent's sale to his sons in 1984 of a remainder interest in his ranch for its actuarial value "as calculated by the appropriate factor set forth in the Treasury Regulations constitutes an adequate and full consideration under section 2036(a)." The court holds that the sale was sufficient to avoid inclusion of the ranch in the decedent's gross estate for estate tax purposes under IRC § 2036. The court explains that the present receipt of the actuarial value of a remainder interest in property is the economic equivalent of the future receipt of the property itself.[516] The court stated:

[513] For income tax purposes, however, it appears that the purchaser is taxed as a trust beneficiary. See Priv. Ltr. Rul. 95-12-002 (Mar. 24, 1995), in which the IRS concluded that the purchaser of a remainder interest is a beneficiary for purposes of IRC §§ 661 and 662.

[514] It follows from this analysis that if *C* had been a skip person with respect to the original transferor, the sale could be treated as a taxable distribution, giving rise to a GST tax at that time. Thus, if the facts concerning the remainder had been reversed so that *G* or *G*'s estate was the named remainder beneficiary and *C* had purchased *G*'s interest at its full actuarial value, then *G* should be considered to have received a taxable distribution equal to the proceeds of the sale.

[515] 116 F.3d 749 (5th Cir. 1997). Estate of D'Ambrosio v. Commissioner, 101 F.3d 309 (3d Cir. 1996), *cert. denied*, 520 U.S. 1230 (1997), and Estate of Magnin v. Commissioner, 184 F.3d 1074 (9th Cir. 1999) both reached the same result as *Wheeler* on the same issue. All three courts criticized Gradow v. United States, 11 Cl. Ct. 808 (1987), *aff'd*, 897 F.2d 516 (Fed. Cir. 1990), which had reached the opposite conclusion on the same issue.

[516] 116 F.3d at 767. The 1984 transfer took place seven years before the decedent's death. The decedent retained a life estate in the ranch. IRC § 2702 did not apply because the sale took place before IRC § 2702's effective date; IRC § 2702 is inapplicable to transfers made on or before October 8, 1990. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602(e), 104 Stat. 1388 (1990). Nevertheless, it appears that the court's reasoning remains applicable to cases subject to IRC § 2702.

> The sale of a remainder interest for its actuarial value does not deplete the seller's estate. "The actuarial value of the remainder interest equals the amount that will grow to a principal sum equal to the value of the property that passes to the remainderman at termination of the retained interest. To reach this conclusion, the tables assume that both the consideration received for the remainder interest and the underlying property are invested at the table rate of interest, compounded annually." [Martha W. Jordan, *Sales of Remainder Interests: Reconciling* Gradow v. United States *and Section 2702*, 14 VA. TAX. REV. 671, 692–93 (1995), citing Keith E. Morrison, *The Widow's Election: The Issue of Consideration*, 44 TEX. L. REV. 223, 237–38 (1965)]. In other words, the actuarial tables are premised on the recognition that, at the end of the actuarial period, there is no discernible difference between (1) an estate holder retaining the full fee interest in the estate and (2) an estate holder retaining income from the life estate and selling the remainder interest for its actuarial value—in either case, the estate is not depleted. This is so because both interests, the life estate and the remainder interest, are capable of valuation. Recognizing this truism, the accumulated value of a decedent's estate is precisely the same whether she retains the fee interest or receives the actuarial value of the remainder interest outright by a sale prior to her actual death.[517]

Although *Wheeler* involved a sale, the same reasoning would indicate that, if discrepancies in the transfer tax rates are ignored, a present payment of an estate tax or gift tax based on the actuarial value of a remainder interest is the equivalent of a future payment of GST tax based on the full value of the property—that is to say, the GST tax that would have applied when the remainder beneficiary would have come into possession of the property upon the termination of the prior possessory interest.[518] Therefore, it would be consistent with the reasoning of *Wheeler* to change the transferor of the entire trust in the above example from *W* to *C*, regardless of whether the remainder interest is subject to an estate tax, subject to a gift tax, or sold for an amount equal to its value determined for estate or gift tax purposes.

In Private Letter Ruling 2001-07-015, the IRS, however, reaches a different conclusion.[519] It adopts the third possibility, i.e., that the transferor of the remainder interest becomes the transferor of only a fraction of the underlying property, based on the ratio of the actuarial value of the remainder interest to the full value of the underlying property. This private ruling involved the transferor's child assigning a vested remainder interest in a charitable lead annuity trust to the child's children (the grandchildren of the original transferor). The IRS ruled that the child of the original transferor would become the transferor over only the portion of the trust represented by the actuarial value of the remainder interest at the time of the assignment. The transferor would not change with respect to the remaining portion of the trust.

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[517] 116 F.3d at 762.

[518] For a discussion of differences in the transfer tax rates and the impact on the effective tax rates of the tax exclusive or tax inclusive nature of the different transfer taxes, see *supra* § 20.

[519] Priv. Ltr. Rul. 2001-07-015 (Feb. 16, 2001).

There is yet a third source of authority for the treatment of assignments of remainder interests. It is example 4 of Treas. Reg. § 26.2652-1(a)(5), involving the transfer of an income interest, which is quoted below.

> T transfers $100,000 to a trust providing that all of the net income is to be paid to T's child, C, for C's lifetime. At C's death, the trust property is to be paid to T's grandchild. C transfers the income interest to X, an unrelated party, in a transfer that is a completed transfer for Federal gift tax purposes. Because C's transfer is a transfer of a term interest in the trust that does not affect the rights of other parties with respect to the trust property, T remains the transferor with respect to the trust.

The application of the example to a transfer of a remainder interest (as opposed to an income interest) is susceptible to several interpretations and leaves a number of unanswered questions. A possible negative implication of the last sentence of the example is that, if the interest transferred is not a term interest, or if it does "affect the rights of other parties with respect to the trust property," *T* would not remain the transferor with respect to the entire trust. Of course, the example does not explain to what extent, if any, the transferor would change under these circumstances. Nor does it provide any guidance as to when a transfer of a trust interest would be considered to "affect the rights of other parties with respect to the trust property."

The statement that there is no change in the transferor of the property remaining in the trust also leaves unaddressed the GST tax consequences of the gift of the income interest. Presumably, there is a change in the transferor with respect to that interest. For example, if *X*, the person to whom *C* assigned the income interest, is in the same generation as *C*'s child and thus the generation of *T*'s grandchild, the transfer of the income interest by *C* to *X* should not be a direct skip from *C*, and the distributions of income to *X* should not be taxable distributions. It is possible, that such a transfer by *C* could be treated as a taxable termination and then, under the move-down rule of IRC § 2653, the transferor would be assigned to *C*'s generation, even though *C* does not become the transferor of any portion of the trust. Subsequent distributions to *X* would not be taxable distributions once a taxable termination occurs and the transferor is reassigned to *C*'s generation. If *X* were in the same generation as *C*'s grandchildren, then, presumably, *C*'s transfer of the income interest would have constituted a direct skip; however, if the transfer were a sale, under IRC § 2624(d), the direct skip would be reduced by the consideration paid by the transferee.

Alternative

<u>Clarify the GST Tax Law to Conform to the Estate and Gift Tax Laws by Treating the Actuarial Value of a Remainder Interest as the Full Value of the Underlying Property Encumbered by the Term Interest</u>. 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.

Current Law. IRC §§ 2701 and 2702 provide special methods for the purpose of valuing a transfer for gift tax purposes.[520] If IRC §§ 2701 and 2702 apply, the value on which the gift tax must be paid can be greater than the fair market value of the interests in the property that the donor transfers. Both IRC §§ 2701 and 2702 apply "solely for purposes of determining whether a transfer [of certain property interests to or for the benefit of certain donees] is a gift (*and the value of such transfer*)."[521]

IRC § 2612(c) provides that a transfer to a skip person subject to gift tax is a direct skip. IRC § 2623 provides that the taxable amount of a direct skip upon which the GST tax is to be paid is "the value of the property received by the transferee." If a donor allocates the GST exemption on a timely filed gift tax return or the GST exemption is deemed allocated to a lifetime transfer by reason of the automatic allocation rules, the GST tax rate applicable to any resulting generation-skipping transfer is determined according to an inclusion ratio. Under IRC § 2642(b)(1)(A), the inclusion ratio is determined with reference to the "value of the property . . . as finally determined for purposes of chapter 12 [the gift tax]."[522] If IRC §§ 2701 and 2702 apply only for gift tax purposes, it appears that the value on which the law determines a donor's gift tax liability may not be the value on which the law determines, for GST tax purposes, either the taxable amount or the inclusion ratio, which in turn, under IRC § 2641, determines the GST tax rate.

Neither the Code nor the regulations make clear whether the value determined under IRC §§ 2701 or 2702 applies for GST tax purposes. The GST tax regulations do not address this question, notwithstanding that Treasury adopted them after the regulations under IRC §§ 2701 and 2702.[523] Whenever, for GST tax purposes, the value of property is based on the value at the time of the gift, a lack of symmetry between the value used for gift tax purposes and the value used for GST tax purposes will cause complexity and confusion. If a special value that is greater than fair market value is warranted for gift tax purposes, it is hard to see how that special value also would not be appropriate for GST tax purposes.

[520] For further discussion of these provisions, see *supra* § 18.
[521] IRC §§ 2701(a)(1), 2702(a)(1) (emphasis added).
[522] *See* IRC § 2632(b) (deemed allocation for lifetime direct skips). Treas. Reg. § 26.2642-2(a)(1) refers to "fair market value" and not just "value."
[523] *See* T.D. 8395, 1992-1 C.B. 316, the preamble to the regulations under IRC § 2702 (refers to the GST tax).

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. This means that the special valuation rules apply for the purpose of determining the taxable amount under IRC § 2623 and the inclusion ratio on a direct skip under IRC § 2642(b)(1)(A). If IRC §§ 2701 and 2702 were to apply to other types of transfers, taxpayers could avoid their application by making a late allocation of their GST exemptions, which simply would result in greater complexity in the operation of the GST tax law.

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.

Current Law. The analogue to the unified credit under the GST tax law is the GST exemption. After 2003, the GST exemption increases in amount with the scheduled increases in the estate tax applicable exclusion amount.[524] IRC § 2642 implements the exemption in the form of an inclusion ratio that is then used to determine the rate of tax under IRC § 2641. The inclusion ratio, in effect, determines the portion of each taxable distribution that is subject to the GST tax and the portion of a trust that is subject to the GST tax upon a taxable termination. For example, if a trust has an inclusion ratio of 50 percent and the GST tax rate is 50 percent, each taxable transfer would be taxed at the rate of 25 percent. A taxable transfer includes: (i) a distribution from a trust to a skip beneficiary and (ii) the termination of the interest of the last non-skip beneficiary to have an interest in the trust.[525] For example, if a transferor establishes a trust that directs the trustee to distribute income and corpus to the transferor's lineal descendants, a distribution of either income or corpus to a grandchild is a taxable distribution.[526] When a transferor's children no longer have any beneficial interests in the trust, such as upon the death of the last surviving child, a taxable termination occurs and the entire trust is subject to the GST tax.[527] If the trust has a zero-inclusion ratio, the generation-skipping transfers—both the taxable distributions and the taxable terminations—do not incur a GST tax. Even if the trust continues for the benefit of more than two generations of the transferor's descendants, any generation-skipping transfers do not incur a GST tax.

These rules encourage the use of long-term trusts in two ways: (i) the GST exemption, if it is assigned to the trust before the appreciation in the value of the corpus occurs, prevents taxation of the appreciation in the exempt trust, thereby minimizing the GST tax, and (ii) the GST exemption exempts or reduces the tax on successive generation-skipping transfers from the

[524] EGTRRA § 521(amending IRC § 2631 and effective after 2003). *See* Appendix B (scheduled increases of the estate and gift tax applicable exclusion amounts and the GST exemption amount).
[525] IRC § 2612(a), (b).
[526] The example assumes that the grandchild's parent is alive. An exception is made for transfers to persons with a deceased parent. IRC § 2651(e).
[527] IRC §§ 2612(a), 2622(a).

same trust. In response to the GST exemption, a growing number of states have repealed their rules preventing perpetuities, so that transferors can, for an unlimited time, use their GST exemptions to prevent taxation of appreciation and of successive generation-skipping transfers.[528]

The rules governing the GST exemption also place a high premium on the timely and effective allocation of the exemption to a trust. Missed allocations of the GST exemption create significant potential GST tax liability. The compounding factor and the impact of appreciation can increase the GST tax exponentially. At a 50 percent GST tax rate, for example, the failure to allocate the GST exemption to a gift to a trust of $1 million, which later increases in value to $6 million, would result in $3 million of GST tax liability. All of the GST tax could have been avoided if the transferor had allocated the GST exemption at the time the transferor made the gift. One widely known settlement involved an accounting firm paying several million dollars to resolve a case involving the failure to allocate the GST exemption.[529] In fact, the potential liability for mistakes in allocating the GST exemption has caused some practitioners to consider the preparation of gift tax returns too risky for the fees involved and to decline to prepare them. In a self-reporting system, the difficulties of taxpayer compliance can place significant administrative burdens on the IRS. Although the EGTRRA made several changes to the GST exemption rules that ameliorate the problem of missed allocations of the exemption, these reforms will sunset with the rest of the EGTRRA after 2010.[530]

The GST exemption rules also encourage the use of multiple trusts to maximize the benefit of the exemption. A transferor can minimize the GST tax, if the transferor creates one trust for the benefit of the transferor's descendants and allocates a sufficient portion of the GST exemption amount to make that trust entirely exempt from the GST tax, and creates another trust also for the transferor's descendants that is not exempt from the GST tax. The creation of the two trusts allows a trustee to use the nonexempt trust for distributions to the transferor's children. Those distributions do not result in GST tax and do not deplete the exempt trust, which remains available for the transferor's grandchildren and more remote descendants. Distributions from the exempt trust do not result in GST tax because of the exempt trust's zero-inclusion ratio. Unless the transferor creates multiple trusts in this manner, a trust distribution to a skip beneficiary could incur GST tax, even if the aggregate amount passing to skip beneficiaries does not exceed the transferor's GST exemption amount. For example, if a transferor transferred $100,000 to a trust for the primary benefit of the transferor's children, but directed the trustee to distribute $1,000 to each of the transferor's five grandchildren upon their graduating from college, notwithstanding that the aggregate amount the trustee distributes to the grandchildren is only $5,000, each gift of $1,000 would be subject to some GST tax, unless the entire trust had an inclusion ratio of zero.

[528] Corporate trustees have used liberal state laws as a marketing device to bring trusts into their states, and some states have felt pressure to repeal their own rules preventing perpetuities, so that their corporate fiduciaries residing in those states are not at a competitive disadvantage.
[529] Priv. Ltr. Rul. 97-36-032 (Sept. 5, 1997) (concerning the tax effects of the payment made pursuant to the settlement).
[530] *See* IRC § 2642(g).

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.[531] If a trust has an inclusion ratio of one, then 100 percent of a taxable distribution to a skip beneficiary would be subject to the GST tax, and 100 percent of the value of the trust would be subject to the GST tax upon the termination of the interest of the last non-skip beneficiary to have an interest in the trust. This approach would leave the current GST exemption rules in place, but minimize the tax incentive to create long-term or perpetual trusts. Although this approach limits the benefits from the GST exemption to a definite period of time, and, thereby, caps the economic consequences of a missed allocation, if the term limit is as long as 90 years, the economic consequences of a missed allocation still potentially could be quite severe. This approach does nothing to relieve the compliance complexities that the GST exemption rules create.

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. The following examples illustrate this alternative.

> *Example 1: A taxable distribution to another trust. G* creates a trust for the benefit of her children and more remote descendants that has an inclusion ratio of zero. The trustee distributes the corpus of this trust (the "transferor trust") to another trust *G* had created for the benefit of her grandchildren and more remote descendants (the "transferee trust"). The distribution would not incur the GST tax. Although the transferee trust is a skip person, because all the beneficiaries of the transferee trust are skip persons, and the distribution, therefore, is a taxable transfer, the zero-inclusion ratio of the transferor trust would eliminate GST tax liability.[532] Under current law, the transferor trust's zero-inclusion ratio carries over to the transferee trust. Under this alternative, the transferor trust's inclusion ratio would not carry over to the transferee trust. The transferee trust's inclusion ratio would be one, unless *G* had allocated her remaining GST exemption, if she had any, to it. Despite the new inclusion ratio assigned to the transferee trust, however, distributions from the transferee trust to *G*'s grandchildren would not incur the GST tax because, under the generation move-down rule of IRC § 2653(a), after a generation-skipping transfer occurs, whether or not GST tax is due, the trust is treated as though *G* were reassigned to her children's generation, which is one generation older than the generation of the eldest beneficiary of the transferee trust, that is, the grandchildren's generation. Unlike under current law, however, a distribution from the transferee trust to the grantor's great-grandchildren and more remote descendants would be subject to the GST tax and not exempt from tax liability.

> *Example 2: A taxable termination.* The facts are the same as under example 1, except that the trustee does not distribute the corpus to another trust. *G*'s last surviving child dies, which results in a taxable termination.[533] The trust does not owe a GST tax because the trust has a zero-inclusion

[531] A 90-year rule would coincide with the UNIFORM STATUTORY RULE AGAINST PERPETUITIES, which adopts a 90-year permissible vesting period, at the end of which, if all the interests have neither failed nor vested, courts have the authority to reform the trust to provide for vesting of interests in a manner that approximates the transferor's plan of distribution. UNIFORM STATUTORY RULE AGAINST PERPETUITIES § 1(a)(2), (b)(2), (c)(2) (amended 1990), 8B U.L.A. 236–37 (2001).
[532] IRC §§ 2612(b) (taxable distribution), 2613(a)(2) (a trust as a skip person).
[533] IRC § 2612(a).

ratio.[534] After the taxable termination, however, the trust would acquire a new inclusion ratio of one. Again, under the generation move-down rule of IRC § 2653(a), *G* is reassigned to the generation of her children, so that when the trustee makes distributions to grandchildren they are not subject to the GST tax. Taxable distributions to *G*'s great-grandchildren, however, would result in a GST tax. At the death of the last surviving grandchild, another taxable termination would occur, and the trust would be subject to the GST tax and not exempt from tax liability.[535]

As the examples demonstrate, this approach would eliminate the incentive to create long-term trusts. Although this approach limits the benefits of the GST exemption to, at most, the lifetime of the last surviving member of the generation immediately below the transferor, and, thereby, limits the economic consequences of a missed allocation, the economic consequences of a missed allocation still potentially could be quite severe. As with the first alternative, this approach does nothing to relieve the compliance complexities that the GST exemption rules create.

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. This change would allow a transferor to achieve the benefits of having multiple trusts and to avoid the administrative complications of having to sever a trust. A trust that has an inclusion ratio between zero and one loses the benefit of the GST exemption whenever a trustee makes a distribution to a non-skip beneficiary. In addition, whenever a trustee makes a distribution to a skip person, no matter how small that amount, it is subject to some GST tax. Multiple trusts can avoid these tax consequences. If Congress permits a trustee to allocate distributions within one trust, it would eliminate the incentive for creating multiple trusts. The following example illustrates this alternative.

Example: Distributions to children and grandchildren. A trust for the benefit of *G*'s lineal descendants contains $1.2 million of assets and has an inclusion ratio of 50 percent. The trustee distributes $100,000 to *G*'s child, *C*. Although that distribution is not a generation-skipping transfer because *C* is not a skip person, under current law it nevertheless uses some of *G*'s GST exemption.[536] The trustee also distributes $1,000 to *G*'s grandchild, *GC*, which is a taxable distribution.[537] With an inclusion ratio of 50 percent, under current law, $500 of that taxable distribution is not exempt from GST tax, even if that is the only generation-skipping transfer ever made from this trust.

If the trustee were to sever the trust and create two separate trusts, one of which has an inclusion ratio of one and the other of which has an inclusion ratio of zero, these tax consequences would be avoided. Following the severance, the trustee would choose to make the $100,000 distribution to *C* from the trust that has an inclusion ratio of one, because the distribution to *C*, a non-skip person, is not taxable. In contrast, the trustee would choose to make the $1,000 distribution to *GC* from the trust that has the zero-inclusion ratio, and, therefore, avoid any GST tax. The rules encouraging the severance of trusts needlessly complicate tax planning.

The benefits of severance can be obtained if the trustee merely keeps an accounting of the distributions and resets the inclusion ratio for a single trust. Under this alternative approach,

[534] The trustee is liable for the GST tax upon a taxable termination. IRC § 2603(a)(2).
[535] IRC § 2612(a). A taxable termination would occur only if the grandchildren were survived by their own children, who would be skip persons. IRC §§ 2613(a)(1), 2653(a).
[536] IRC §§ 2612(b), 2613(a)(1).
[537] *Id.*

> Congress would permit the trustee to allocate the $100,000 distribution to the portion of the trust that has the inclusion ratio of one and reset the inclusion ratio for the trust. Instead of the inclusion ratio being 50 percent ($600,000 ÷ $1.2 million), the inclusion ratio would be 45.45 percent ($500,000 ÷ $1.1 million). The tax consequences are the same as if there were separate trusts. With this rule, Congress would eliminate the incentive to create multiple trusts and the complications of estate planning that accompany the creation and maintenance of multiple trusts.

This approach would be especially useful in the case of trusts that primarily benefit non-skip beneficiaries but make small distributions to skip beneficiaries. In the above example, the distribution to the grandchild was only $1,000. If the trust was primarily for the benefit of the transferor's children, and benefited the transferor's grandchildren only incidentally, the severance of the trust is not practicable. Imposing the GST tax on such a small gift to a grandchild does not seem to further the underlying policy of the GST tax law. Although this approach does not eliminate the incentive to use long-term trusts to minimize the GST tax, it does reduce the incentive to create multiple trusts for the same beneficiaries, simplifies the administration of the GST tax law, and reduces the risk of missed allocations of the GST exemption to trusts. This approach could be adopted in addition to, or instead of, either alternative 2 or 3 described above.

4. <u>Eliminate the Inclusion-Ratio Approach, and Permit a Trustee to Elect Which Generation-Skipping Transfers Use the GST Exemption Allocated to the Trust</u>. 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. This approach would eliminate the incentive to use long-term trusts to minimize the GST tax, because it would freeze the GST exemption at the amount initially assigned to a trust. The following example illustrates this alternative.

> *Example 1: A trustee assigns the GST exemption to taxable distributions. G* funds a trust with $600,000 and assigns $600,000 of the GST exemption to the trust. *G* directs the trustee to distribute income or corpus to *G*'s lineal descendants. Two years later, the trust has appreciated to $750,000. Under current law, the trust would have a zero-inclusion ratio, making the entire $750,000 exempt from GST tax. In contrast, this approach would freeze the GST exemption available to $600,000. This does not mean, however, that each taxable transfer would incur GST tax. Rather than using the inclusion ratio to determine the amount of GST tax liability, the trustee would assign the GST exemption to particular distributions. If the trustee distributes $50,000 to *G*'s child, *C*, and $10,000 to *G*'s grandchild, *GC*, the trustee would minimize taxes by not assigning any of the GST exemption to *C*'s distribution and assigning $10,000 of the exemption to *GC*'s distribution. The trustee would have $590,000 of *G*'s GST exemption remaining to assign to later taxable 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. Rather, the GST tax would be deferred until a distribution was made to a skip beneficiary.

If Congress retains current law and continues to impose tax upon the termination of an interest of a non-skip person, at the taxable termination, the GST tax would be based on that portion of the value of the trust assets that exceeds the amount of the remaining GST exemption. The following example illustrates the application of this alternative and the possible modification to it with regard to taxable terminations.

> *Example 2: Termination of the interests of all children*. The facts are the same as in example 1. Before the trustee makes any further distributions, *G*'s last surviving child dies. At that time, the remaining amount of the GST exemption is $590,000 ($600,00 GST exemption – $10,000 distribution to *GC*) and the value of the trust's assets has appreciated to $690,000. The trust would owe GST tax on $100,000 ($690,000 – $590,000 remaining GST exemption).[538] If the termination of the interests of *G*'s children is ignored, then no generation-skipping transfer would occur until the trustee makes a distribution to the grandchildren or to more remote descendants. At that time, the trust could assign the remaining amount of GST exemption to that distribution and continue to treat subsequent distributions similarly until the exemption amount is reduced to zero.

With the GST exemption no longer sheltering future appreciation, the postponement of a generation-skipping transfer until the time a skip person receives the property outside the trust does not create any tax advantages. Moreover, it eliminates the need for the move-down rule of IRC § 2653(a).

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. Other countries have adopted this approach. In the United Kingdom, a periodic tax applies to discretionary trusts every 10 years.[539] It does not apply to a trust if a beneficiary has the right to all of the income from the trust, because, under the law of the United Kingdom, if the beneficiary has the right to all of the income from the trust, the trust assets are included in the beneficiary's tax base for death tax purposes.[540] Canada imposes a gains tax on deathtime and lifetime transfers. To prevent transferors from evading that tax, it also imposes a deemed disposition tax on trusts every twenty-one years.[541] Although the context of the periodic tax on trusts is quite different than in the United States, the experience of the United Kingdom and Canada with a periodic tax suggests this alternative is administratively feasible. The advantage of this approach is that it would discourage the creation of long-term and perpetual trusts and multiple trusts. It also would eliminate the complexities generated by the GST exemption rules.

D. Direct Skips

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

Current Law. A direct skip is "a transfer subject to a tax imposed by chapter 11 [estate tax law] or 12 [gift tax law] of an interest in property to a skip person."[542] The combined tax rate

[538] IRC § 2603(a)(2) (imposing tax liability on a trust for a taxable termination).
[539] Inheritance Tax Act, 1984, c. 51, §§ 43, 58, 64, 66–67 (Eng.).
[540] *Id*. at §§ 5, 49.
[541] For further description of the Canadian system, see *infra* Appendix A, Exhibit A.
[542] IRC § 2612(c)(1).

on a direct skip can be extremely high. When a transferor makes a gift to a grandchild that is simultaneously a taxable gift and a direct skip and the transfer tax rate is 50 percent, for example, the combined tax rate is over 55 percent of the gross transfer and 125 percent of the net transfer amounts.[543] These high rates are likely to discourage gifts to grandchildren and more remote descendants or to persons assigned to such generations even when there is no tax avoidance purpose or intent. The 1976 version of the GST tax law did not tax direct skip transfers, but only transfers made to trusts (or the equivalent) that split benefits between two younger generation levels. Thus, a transfer directly to a grandchild was not subject to the 1976 version of the GST tax.[544]

When Congress enacted the current version of the GST tax, it determined that a tax on direct skips was necessary.[545] Commentators observed that wealthy transferors easily could avoid the 1976 version of the GST tax by either skipping the child level completely or making separate transfers to trusts for each generation of descendants ("layering").[546] For example, rather than funding one trust for each child and that child's descendants, instead, a wealthy person could leave some amount directly to a child and the rest to a trust solely for the benefit of that child's children. Layering avoided or minimized the GST tax under the 1976 version, because it eliminated or limited the splitting and shifting of beneficial interests within a trust from one younger generation to the next. Critics were concerned that the ability to skip a generation completely and to use layering was unfair, because these techniques were available only to the wealthiest taxpayers.

The 1976 version imposed the GST tax on any nonbeneficial powers in the same manner as a beneficial interest, although several significant exceptions existed.[547] The taxation of powers prevented the use of trusts to control property and thus indirectly to benefit the power holder who had no taxable beneficial interest in the trust property. Direct skip taxation simplified the tax law by subjecting a trust to GST tax when no member of an intervening younger generation has been given a beneficial interest, thus eliminating any need to tax powers.

The GST tax on a direct skip roughly is equivalent to the gift tax that would have been imposed had the transferor made a gift to the transferor's child and the child in turn had made a

[543] IRC § 2515 increases the amount of the gift by the amount of the GST tax. When a transferor makes a bequest when the transfer tax rate is, for example, 50 percent and at a later time a generation-skipping transfer occurs, the combined tax rate is 75 percent of the gross amount of the transfer and 300 percent of the net amount of the transfer. When a transferor makes a gift and the transfer tax rate also is 50 percent and at a later time a generation-skipping transfer occurs, the combined tax rate is 67 percent of the gross amount of the transfer and 200 percent of the net amount of the transfer. The differences result from the fact that the gift tax and the GST tax on direct skips are tax exclusive, and the estate tax and the GST tax on taxable terminations and taxable distributions are tax inclusive. IRC § 2603. For further discussion of tax inclusivity and exclusivity, see *supra* § 20.

[544] GENERATION-SKIPPING TRANSFER TAX SIMPLIFICATION PROPOSALS 1984, *supra* note 364, at 16.

[545] Id.

[546] Id.

[547] IRC § 2613(b) (1976 version of the GST tax) (defining a taxable termination as the termination by death, lapse of time, exercise or nonexercise, or otherwise) of an interest or a power in a generation-skipping trust of any younger generation beneficiary who is assigned to any generation older than that of any other person who is a younger generation beneficiary of that trust), (d) (1976 version of the GST tax) (defining a power as a power to establish or alter beneficial enjoyment of the corpus or income of the trust).

gift to the transferor's grandchild.[548] In other words, the GST tax is imposed on the *absence* of a transfer to the first generation below the transferor. The direct skip raises a number of problems. First, an outright transfer to a child who then transfers the same property outright to a grandchild does not have a similar substantial economic effect as an outright transfer to a grandchild, although the wealth transfer tax system treats the two types of family transfers equivalently. Second, there can be significant nontax reasons for making gifts to persons who are members of remote generations. Taxation of direct skips seems particularly unfair in a situation in which the transferor and the transferor's child are estranged. The transferor is forced into the choice of disinheriting the child's descendants or paying a high rate of tax. A third problem is that direct skips prevent only one level of layering. Layering remains an advantage under the current GST tax law, because it assesses only one GST tax regardless of how many generations a transferor skips. For example, a gift to a great-grandchild is not treated as two generation-skipping transfers but only one. Finally, the combined effective rate imposed on a transfer to a grandchild is relatively high when compared to a transfer to a child, a sibling, or a parent.

Alternatives

1. <u>Limit Generation-Skipping Transfers to Taxable Distributions and Taxable Terminations</u>. Congress could repeal IRC § 2612(c) and not treat direct skips as generation-skipping transfers. This alternative may require Congress to treat nonbeneficial powers as the equivalent of beneficial interests. Moreover, it could lead to the reintroduction into estate plans of transfers made to trusts that exclude children as beneficiaries. The advantage of this alternative is that it reduces the tax on gifts to remote descendants.

2. <u>Reduce the Rate of Tax on Direct Skips</u>. Congress could reduce the rate of the GST tax on direct skips. The rate of the GST tax on direct skips already is effectively lower than the rate of the GST tax on taxable distributions and taxable terminations, because the tax base for direct skips is tax exclusive while the tax base for taxable distributions and taxable terminations is tax inclusive.[549] A reduced nominal tax rate nevertheless may be warranted. It would be an acknowledgment of the risk of tax avoidance through layering, but it also would be an acknowledgment that a transfer that includes members of the generation immediately below that of the transferor (the transferor's children) is not equivalent to a transfer that excludes those members (the transferor's children) and includes only more remote lineal descendants.

E. Transfers to Persons Unrelated to the Transferor

Issue: <u>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</u>.

Current Law. The GST tax applies to a transfer to any person who the statute assigns to a generation more than one generation younger than that of the transferor, even if the person is not a relative of the transferor. IRC § 2651(d) assigns a nonrelative to a generation more than one

[548] IRC § 2515, which requires the transferor to increase the value of a gift that results in a GST tax by the amount of the GST tax itself.
[549] IRC §§ 2603, 2621–23. For further discussion of the tax exclusive treatment of direct skips, see *supra* note 545.

generation younger than the transferor's, if the person is more than 37 ½ years younger than the transferor. For example, a bequest to a housekeeper, friend, or business colleague would be subject to the GST tax, if the person were more than 37 ½ years younger than the transferor.

Even if the transferor has a GST exemption available to assign to a bequest to such a person in order to shield the transfer from the GST tax, typically the GST exemption is preserved for the transferor's descendants and the GST tax liability is apportioned to the nonrelative recipient. While the amount of tax may seem trivial to the estate of a wealthy transferor, the tax burden can be significant to a nonrelative, such as a chauffeur, secretary, or gardener. In addition, collecting the information necessary to determine a generation assignment, including a person's birth date, can be intrusive, awkward, and unreliable.

Alternative

Exclude Gifts to Nonrelatives from the GST Tax. Congress could exclude transfers to nonrelatives from the GST tax. A GST tax on gifts and bequests to unrelated persons is not necessary to prevent estate tax avoidance. There is no reason to believe that a gift or bequest to a nonrelative, such as a housekeeper or nurse, who is more than 37 ½ years younger than the transferor, is made to avoid estate tax at the generation of the transferee's parent. One difficulty with limiting the GST tax to family members is that it results in imposing harsher tax rules on transfers to family members than on transfers to unrelated persons. Precedent exists, however, in the valuation rules under IRC §§ 2701 through 2704 and elsewhere, to impose stricter rules on gratuitous transfers to family members than to unrelated persons.

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.

Current Law. IRC § 2651(d) assigns unrelated persons to generations based on age for the purpose of applying the GST tax. IRC § 2651(d)(1) assigns a person who is not more than 12 ½ years younger than the transferor to the transferor's generation. IRC § 2651(d)(2) assigns a person who is more than 12 ½ years but not more than 37 ½ years younger than the transferor to the same generation as the transferor's child. IRC § 2651(d)(3) assigns a person who is more than 37 ½ years but not more than 62 ½ years younger than the transferor to the same generation as the transferor's grandchild, and so forth. Put differently, the generation assignment rules treat each generation as 25 years long, but place the transferor in the middle of the transferor's generation.

This means that the GST tax currently applies to transfers to nonrelatives, if the transferee is more than 37 ½ years younger than the transferor. In reality, a person who is slightly more than 37 ½ years younger than another person is not likely to be two generations younger than that other person. If a typical generation is 25 years long, then it would seem that the generation assignment rules would consider only persons more than 50 years younger than the transferor to be skip persons. The concern about the generation assignment rules arises only if the GST tax continues to apply to transfers to unrelated persons.[550]

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. The effect of this change would be to place the transferor at the beginning of the transferor's generation, rather than in the middle. This more liberal generation assignment rule is unlikely to lead to abuse, because transferors presumably would not make transfers to unrelated persons to avoid an estate or gift tax at the generation of those transferees' parents.

[550] For a discussion of transfers to unrelated persons, see *supra* § 27.E.

APPENDIX A
ALTERNATIVES TO THE CURRENT FEDERAL WEALTH TRANSFER TAX SYSTEM

INTRODUCTION

This Appendix presents three alternatives to the current federal wealth transfer tax system:[1] (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;[2] and (iii) a deemed-realization system, which treats gratuitous transfers as realization events for income tax purposes.[3] Part I describes the operation of each alternative tax system. Part II compares the alternative tax models to each other and to the current federal wealth transfer tax system.[4] The discussion focuses on particular wealth transfer tax issues, such as rate structure, valuation, and treatment of different types of lifetime transfers. Both parts analyze each alternative as a model of its kind. They do not presume that Congress necessarily will incorporate features of the existing wealth transfer tax system, such as rules that favor closely held businesses, into any or all of the alternatives.

The Appendix sometimes addresses, but does not fully discuss, topics that the Report otherwise covers, such as various possible reforms of the estate, gift, and generation-skipping transfer taxes or improvements to IRC § 1022's modified carryover basis rule, which takes effect in 2010 upon repeal of the estate and GST taxes.[5] When problems and alternative responses raised in the Report emerge under one or more of the alternative systems, the Appendix addresses them. For example, the deemed-realization system requires a determination of the transferor's bases in transferred assets. Some of the discussion of the modified carryover basis rule, therefore, is pertinent to the application of a deemed-realization system.[6]

In consideration of the alternative tax systems, it is important to keep in mind that, regardless of whether a transfer tax places liability on the transferor or on the transferee, the burden of *all* transfer taxes ultimately falls on the *transferee*, and not the transferor. Under the existing estate and gift tax laws, the transferee ultimately bears the burden of the taxes, although those taxes nominally are imposed on the transferor or the estate.[7] Under the deemed-realization

[1] The inheritance tax option is excluded because, except for the rate, valuation, and exemption structure, it essentially is the equivalent of an estate tax.
[2] The income-inclusion system essentially is a repeal of IRC §§ 101(a) and 102(a).
[3] Congress also could combine the systems. For example, it could enact an income-inclusion system and supplement it with an estate tax or a generation-skipping transfer tax with a high exemption amount.
[4] The Appendix does not consider possible reforms to the current estate tax law presented in §§ 16–27 of the Report.
[5] EGTRRA § 901 (reinstating the law in effect in 2001).
[6] For a discussion of the alternative of a deemed-realization system in the consideration of the modified basis rule, see §§ 8 and 15 of the Report.
[7] Well-advised transferors take into account the tax liabilities attributable to each gratuitous transfer and allocate their property to various beneficiaries accordingly.

system, which also nominally taxes the transferor or the estate, the income tax liability ultimately falls on the transferee.[8] An accessions tax and an income-inclusion system determine the tax with reference to the transferee, and not the transferor. An accessions tax makes the transferee the taxpayer, determining tax liability by taking into account the cumulative lifetime gratuitous receipts of the transferee.[9] The income-inclusion system also imposes the tax liability on the transferee. It calculates the transferee's income tax liability by adding the value of the property that the transferee receives from a gratuitous transfer to that transferee's other income for the year.

[8] Under the deemed-realization system, the tax calculation is a function of the transferor's income tax situation in the year of transfer or death, as the case may be. Regardless of whether the income tax arises by reason of a lifetime or deathtime transfer, the transferee receives that amount that a transferor can afford to transfer after taking into account the tax liability that the transfer generates. If a tax liability arises by reason of death, state law abatement rules could treat the liability either as a "tax" or as a "debt."

[9] For those favoring a transfer tax as a means of preventing undue accumulations of wealth, reference to cumulative gratuitous accessions under an accessions tax is a better method than reference to cumulative gratuitous transfers under current law. Although the transferee is liable for the tax, the accessions tax law could require the transferor or the transferor's executor to withhold the tax.

PART I
OVERVIEW OF THE ALTERNATIVE TAX SYSTEMS

§ 1. Current Federal Wealth Transfer Tax System

The current federal wealth transfer tax system partially unifies the estate, gift, and GST taxes. The estate and gift laws impose a tax on a pay-as-you-go basis, which is to say, they impose a tax at the time the transferor makes a taxable lifetime or deathtime transfer. Under both laws, the tax liability is computed on the current transfer by taking into account the taxpayer's previous gratuitous transfers. In general, therefore, a taxpayer who makes two lifetime transfers of $1 million each and a deathtime transfer of $2 million, for example, is taxed at the same rate on the progressive rate schedule as a taxpayer who makes only a deathtime transfer of $4 million.[10] The transferor or the transferor's estate is liable for the tax.[11]

The GST tax law also imposes a tax on a pay-as-you-go basis. Rather than taking into account prior cumulative transfers, however, the GST tax is imposed at the maximum estate and gift tax rate.[12] Although it does not take into account cumulative transfers, it nevertheless is coordinated with the estate and gift taxes. In general, the GST tax applies only if an intergenerational transfer is not otherwise subject to the estate or gift tax.[13]

Notwithstanding that the federal wealth transfer tax system effectively reduces the amount a transferee receives, it does not directly address undue accumulations of wealth by transferees.[14] The circumstances of transferees are irrelevant under the current wealth transfer tax system, because it imposes a tax based on a transferor's cumulative transfers.

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[10] *See* IRC §§ 2001(b)–(c), 2010, 2502, 2505. For a discussion of the compression of the transfer tax rate schedule by the EGTRRA, see *supra* text accompanying notes 42–43. The annual exclusion, valuation rules, and tax exclusivity of the gift tax, however, permit taxpayers to minimize their tax liabilities by making lifetime, rather than deathtime, transfers. For a discussion of these issues, see §§ 16, 18, and 20 of the Report. On the other hand, deathtime transfers may nevertheless lead to more favorable tax results because of the availability of certain provisions that apply only to estates, such as IRC § 1014, permitting a transferee to take a basis in property acquired from a decedent equal to that property's fair market value at the decedent's death; the special valuation rule of IRC § 2032A, having to do with farmland; or tax deferral provisions, such as IRC § 6166, permitting a time extension for payment of estate taxes for estates holding closely held businesses. For further discussion of some of these provisions, see §§ 7 (IRC § 1014) and 25 (IRC § 6166) of the Report.

[11] IRC §§ 2002, 2502(c).

[12] IRC § 2041(b).

[13] Treas. Reg. § 26.2612-1(b)(1)(i). The exception to the general rule pertains to a direct skip, which IRC § 2612(c) defines as a transfer to a skip person of an interest in property subject to the estate or gift tax. A skip person is someone who is two or more generations below the generation of the transferor, such as a grandchild or great grandchild. IRC § 2613(a)(1). A skip person also includes a trust in which only skip persons hold interests in the trust. IRC § 2613(a)(2)(A). For further discussion of the GST tax, see §§ 4.B and 27 of the Report.

[14] As indicated earlier, regardless of whether a transfer tax places liability on the transferor or the transferee, the burden of *all* transfer taxes ultimately falls on the *transferee*, and not the transferor, and, therefore, reduces the amount a transferee receives.

§ 2. Accessions Tax

An accessions tax is an excise tax on the receipt of a gratuitous transfer of property. It assesses a tax on the basis of the transferee's cumulative lifetime receipts of gratuitous transfers. The tax liability on a taxable accession is computed as follows:

Tax on:
(a) the value of the accession
(b) less deductions and exclusions
(c) plus prior years' accessions
Less tax on prior years' accessions.[15]

Each transferee could have a cumulative lifetime exemption. Taxable accessions (the net of any deductions and exclusions) would be subject to a rate schedule that could either be flat or graduated. Congress could adopt rules that neutralize the incentive to scatter accessions to multiple individuals who are in low rate brackets and have unused lifetime exemptions.[16] If generation-skipping transfers would be a concern, Congress could adopt a number of different mechanisms to tax at a higher rate accessions from family members who are two or more generations older than the transferee.

As a tax based on lifetime receipts of the transferee, an accessions tax promotes equality of treatment among similarly situated transferees, without regard to the source, timing, or circumstances surrounding the accessions. For example, the current wealth transfer tax system, which is transferor oriented, treats an individual who receives all of one decedent's $4 million estate less favorably than an individual who receives a $1 million estate from four different decedents. Similarly, the current wealth transfer tax system treats an individual who receives one-fourth of a $4 million estate less favorably than an individual who receives all of a $1 million estate. These inequalities would disappear in a transferee-oriented system, such as one based on an accessions tax.

Generally, transfers under the current wealth transfer tax system would be considered accessions under an accessions tax. An accessions tax could exclude receipts from a spouse, in whole or in part. Receipts by a charity would not result in an accessions tax, because the charity itself would be exempt from tax. Congress could adopt a *de minimis* rule to exclude from taxation small receipts of cash, holiday and "occasion" gifts, and consumption-item gifts. Congress also could address liquidity concerns related to business assets and other tax-favored assets by adopting rules that defer the taxable event or, as under the current transfer tax system, by deferring the tax, with or without a below-market interest charge.[17] The valuation of an

[15] Essentially, this is the mirror image of the structure of the gift tax return under the current wealth transfer tax system. *See* IRC § 2502(a).
[16] Congress, nevertheless, could allow for a qualified disclaimer, notwithstanding that it could result in an accession to a person who is in a low rate bracket or has an unused exemption. The ability to minimize taxes through a qualified disclaimer is recognized under the current wealth transfer tax system. IRC §§ 2046, 2518, 2654(c).
[17] For a discussion of current rules regarding closely held businesses and deferral of tax on them, see § 25 of the Report.

accession would raise issues similar to those that arise under the current transfer tax laws.[18] The key question that Congress would need to resolve is whether to value what a transferee receives or what a transferor relinquishes.[19]

Prior proposals relating to an accessions tax have grappled with difficult issues that have to do with receipts by and through trusts.[20] The source of the concern is that a trust is not now thought of as a taxable person for transfer tax purposes. Under the current view of trusts, an accessions tax would not treat a transfer made to a trust or the vesting of a trust interest as a taxable event.[21] Rather, a taxable accession would not occur until the trust made a distribution, either from income or corpus.[22] A trust distribution treated as a transfer under an accessions tax stands in sharp contrast to the existing estate and gift tax laws, under which transfers can occur no later than the transferor's death. From the perspective of current law, an accessions tax defers taxation in the case of trusts. In general, deferral is revenue neutral so long as the tax base includes all distributions, both income and corpus.[23] Nevertheless, a taxpayer may obtain an advantage with respect to a given trust, if an accessions tax were to allow the taxpayer to accelerate the taxable event to, for example, the date the transferor funds the trust.[24] Congress could design the tax to prevent accelerations.[25]

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[18] For a discussion of valuation issues under the current law, see § 18 of the Report.

[19] The current gift tax law and aspects of the estate tax law use a value based on what the transferee receives. As a matter of logic, an accessions tax would be based on the value received. Policy and practicality concerns, however, may lead to a different conclusion.

[20] An accessions tax, first proposed in 1945, was considered seriously as an alternative to the integration and unification of the estate and gift taxes in 1976. *See* Joseph M. Dodge, *Comparing a Reformed Estate Tax with an Accessions Tax and an Income-Inclusion System, and Abandoning the Generation-Skipping Tax*, 56 S.M.U. L. REV. 101 (2003); Edward C. Halbach, Jr., *An Accessions Tax*, 23 REAL PROP. PROB. & TR. J. 211 (1988); Harry A. Rudick, *A Proposal for an Accessions Tax*, 1 TAX L. REV. 25 (1945). An accessions tax proposal was included in the 1968 American Law Institute Federal Estate and Gift Tax Project. William D. Andrews, *The Accessions Tax Proposal*, 22 TAX L. REV. 589 (1967). It appears that no country has adopted an accessions tax.

[21] A system that accelerates an accession by a beneficiary to the time a trust interest vests would unnecessarily raise the problem of actuarial valuation, which could result in an interest that is either undervalued or overvalued relative to what the transferee actually receives. Such a system also would create a distinction between vested and nonvested interests. Nevertheless, an accessions tax could treat a transfer of property into a trust in which a single beneficiary holds all beneficial interests as an accession.

[22] If a distribution that constitutes an accession also represents, in whole or in part, taxable income of the trust, an accessions tax should provide a deduction for the income tax liability that a distributee incurs. This is the reverse of the rule under IRC § 691(c), which provides a deduction for estate taxes paid for the purpose of the income tax.

[23] Exemptions and a progressive rate schedule can make deferral tax disadvantageous. For further discussion of deferral, see § 23 of the Report, having to do with the string provisions currently found in the estate tax law.

[24] Some have proposed that beneficiaries, who have substantial interests in trusts, could assign their lifetime exemptions to their interests at the time the transferors complete their transfers to the trusts. Such an assignment could result in the exclusion of all future trust distributions from taxation. The assignment would operate in a manner similar to the current GST exemption with its inclusion ratio rules. *See* IRC §§ 2631–2632, 2641–2642. Edward C. Halbach suggests that an accessions tax should not allow such an assignment by a beneficiary who has a living ancestor, who also is a beneficiary of the trust. Halbach, *supra* note 20, at 247–53.

[25] One way to accelerate the tax might be for a beneficiary to sell an interest in a trust. The sales proceeds would constitute an accession to the beneficiary, as a seller, and the buyer, as an investor, would not be subject to an accessions tax on future distributions. To prevent this strategy, Congress could treat sales of trust interests to related parties as gift assignments or perhaps simply disregard them.

Congress could adopt an alternative approach to contributions to trusts and impose a tax, probably at a high flat rate, on a trust's receipt of assets in excess of a certain high threshold amount.[26] Distributions to beneficiaries would remain subject to an accessions tax, as would any accessions tax attributable to the distributions that the trust pays. To prevent double taxation of the same property, the beneficiary could receive a refundable credit for taxes previously paid by the trust.[27] This approach would acknowledge that control of wealth in the form of an interest held in trust is a valuable asset.

§ 3. Income-Inclusion System

Congress could establish a comprehensive tax base that encompasses gratuitous transfers by repealing IRC §§ 101(a), which excludes receipts of insurance proceeds from gross income, and 102(a), which excludes receipts of gifts and bequests from gross income.[28] The repeal of these two provisions would mean that a recipient includes the amount of a gratuitous transfer in income in the year of its receipt, and that amount would be subject to income tax at progressive rates. The transferor would not be able to take income tax deductions for gratuitous transfers, except for those made to charities.[29]

Like an accessions tax, the income-inclusion system is transferee oriented. Also as under an accessions tax, the taxable event is the transferee's receipt of property, and not the transferor's transfer or the property interest's vesting. One fundamental difference between an income-inclusion system and an accessions tax is the computation of the tax. Under an accessions tax, the computation takes into account the transferee's receipt of prior gratuitous transfers to determine the appropriate tax rate; under the income-inclusion system, the computation depends only on the amount of the transferee's other income and deductions during the year to determine the appropriate tax rate. Accordingly, a lifetime exemption is inappropriate for an income tax, which taxes all income no matter what the source with the exception of an annual allowance, roughly equivalent to a subsistence level, that is excluded from taxation.[30] Nevertheless, Congress could provide *de minimis* rules excluding lifetime transfers of property having a low value or of a consumption character. Congress also could exclude qualifying marital transfers. Charities would not pay tax on receipts of property.[31]

[26] Congress can exclude relatively small trusts from tax at the time transferors fund them. A high threshold would exclude the vast majority of trusts from taxation until distributions are made. To prevent evasion of the threshold by the creation of multiple trusts, Congress would have to apply the threshold by aggregating all the trusts that a transferor creates.

[27] The credit approach is explained in Halbach, *supra* note 20, at 266–67. It uses ratios that obviate any need to calculate interest.

[28] For the rationale and details of an income-inclusion system, as well as its consumption-tax counterpart, see Joseph C. Dodge, *Taxing Gratuitous Transfers Under a Consumption Tax*, 51 TAX L. REV. 529, 589–93 (1996); Joseph C. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 93 HARV. L. REV. 1177 (1978).

[29] The limitations on gifts to charity under IRC § 170 presumably would apply. IRC § 215, which provides for the deductibility of alimony and separate maintenance payments, would continue to apply.

[30] Technically, under an income tax, gratuitous receipts could be subject to a special lifetime exemption, and even special rates, but the resulting tax would resemble an accessions tax.

[31] The transferor presumably would be eligible to deduct charitable contributions under IRC § 170. *See supra* text accompanying note 29.

The valuation of a receipt would raise issues similar to those that arise under the current wealth transfer tax law.[32] Congress could make accommodations for hard-to-value assets and traditionally tax-favored assets, such as family farms, by allowing the transferee to defer the tax. Those transferees who elect deferral would take a basis of zero in the property they receive. Alternatively, Congress could defer the tax and impose interest on the amount of deferred tax, either at market or below-market interest rates.

In contrast to an accessions tax, under the income tax, trusts, other than grantor trusts, are considered separate taxpayers.[33] Accordingly, Congress could treat the receipts of property by trusts as income and tax those receipts at the rates applicable to trusts. Otherwise, Congress could tax trusts and trust beneficiaries in accordance with the rules set forth in Subchapter J.[34]

If it views the income-inclusion system as a form of transfer tax, i.e., as an accessions tax with a different tax base, Congress may be concerned with generation-skipping transfers. One response to that concern could be to impose a periodic tax on trust assets. Alternatively, Congress could impose an excise tax on trust assets when enjoyment of trust income or corpus shifts intergenerationally.

§ 4. Deemed-Realization System

Congress could modify the current income tax law by treating gratuitous transfers as realization events for income tax purposes.[35] The amount realized would be the fair market value of an asset at the time of transfer, and the basis would be the transferor's adjusted basis.[36] In all cases, the transferee would acquire a basis in the property equal to its fair market value. The payment of life insurance proceeds upon the death of the insured would constitute a realization event.[37] Similarly, gains in pension accounts, individual retirement accounts (IRAs), and income in respect of a decedent (IRD) would be included in the income of the decedent on the

[32] For a discussion of valuation issues under the current law, see § 18 of the Report.
[33] *See* IRC §§ 641–664; *see also* IRC §§ 671–678 (grantor trust rules).
[34] Beneficiaries would exclude distributions from the trust deemed to be of amounts previously taxed to the trust, including property that a transferor uses to fund the trust, accumulated income, and accumulated capital gains. It follows that Congress would not treat the tax on property used to fund the trust as a withholding tax with respect to later corpus distributions. Of course, Congress could alter Subchapter J in a manner that would treat a tax on a trust's corpus and accumulated income as a withholding tax under a gross-up/credit system. If Congress were to do that, the credit should not bear interest, because the tax on a trust is not a prepayment of tax. For a general discussion of trust taxation systems, see Joseph C. Dodge, *Simplifying Models for the Income Taxation of Trusts and Estates*, 14 AM. J. TAX POL'Y 127 (1997); Sherwin Kamin, *A Proposal for the Income Taxation of Trusts and Estates, Their Grantors, and Their Beneficiaries*, 13 AM. J. TAX POL'Y 215 (1996).
[35] The details of such a system, as well as comparisons to carryover basis and transfer tax systems, can be found in Joseph C. Dodge, *A Deemed Realization Approach Is Superior to Carryover Basis (and Avoids Most of the Problems of the Estate and Gift Tax)*, 54 TAX L. REV. 421 (2001).
[36] Congress would need to address certain issues, such as a "minimum basis," "grandparented gain," adjustments with respect to transfer taxes, and special basis rules for tangible personal property, in the design of a deemed-realization system.
[37] Identification of the taxpayer might be difficult, especially if Congress considers premiums to be relevant in determining the transferor and more than one person has paid the premiums.

decedent's final tax return. A deemed-realization system has existed in Canada since 1972.[38] The United Kingdom and Australia, both of which have transfer tax systems, treat lifetime gifts, but not bequests, as realization events.[39]

The taxpayer is considered the transferor. Congress would need to adopt rules for determining 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 carryovers. Congress could allow the transferor to qualify for income averaging if that transferor reports a large, positive, ordinary income on the final tax return. Alternatively, Congress could provide a special rate schedule. It also could allow the transferor to carry back any net loss reported on the final tax return.

Congress could exclude qualifying marital transfers from the deemed-realization system. Instead, it could extend the carryover basis rule of IRC § 1041 to marital gifts and bequests. Congress also could adopt carryover basis rules for hard-to-value assets and traditionally tax-favored assets, such as family farms. The shift of trust enjoyment solely to a charitable beneficiary would not be considered a realization event, but the shift from charitable to noncharitable enjoyment would be. Congress could treat a gain on a personal residence in accordance with IRC § 121, which excludes a gain of up to $250,000 on the sale of a personal residence, if the owner meets certain requirements. In addition, Congress could exempt a fixed-dollar amount of gain, or confer "free" additional basis on estate assets, to mimic the current rule that allows assets exempt from the estate tax under IRC § 2010 to obtain a fair market value basis in accordance with IRC § 1014. Further, an exemption would prevent a tax on transferred property that, under the current system, is not subject to either an estate tax or an income tax, because the value of the property does not exceed the applicable exclusion amount provided by IRC § 2010 and the property takes a basis equal to its fair market value under IRC § 1014.

Transfers made to trusts pose no special problems.[40] Presumably, Congress would treat transfers made out of trusts as realization events. If Congress views the deemed-realization system as a substitute for a wealth transfer tax system, it may be concerned with generation-skipping transfers. Congress could address that issue by treating a trust's assets as having been sold and repurchased at periodic intervals, such as 25 years.[41]

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[38] For a description and analysis of the Canadian system, see Lawrence A. Zelenak, *Taxing Gains at Death*, 46 VAND. L. REV. 361 (1993). Exhibit A of this Appendix, which is a paper by Professor Zelenak, describes the Canadian system.

[39] In Australia, but not the United Kingdom, a carryover basis rule has applied to bequests. HUGH J. AULT, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 176, 193–94 (1997).

[40] Some trusts, however, may call for special treatment. For example, Congress could disregard trusts whose beneficial interests are vested in a single person, such as a trust for minors that qualifies for the annual exclusion under IRC § 2503(c). A transfer to the trust would constitute a realization event, but a subsequent transfer by the trust to the beneficiary would not constitute a realization event, and the beneficiary would take the trust's basis.

[41] Canada imposes its deemed-realization tax every twenty-one years in the case of discretionary trusts; single life beneficiary trusts are subject to the deemed-realization tax at the death of the life tenant. Income Tax Act, R.S.C., ch. 1, § 104(4) (1985) (5th Supp.) (Can.).

PART II
A COMPARISON OF THE ALTERNATIVE TAX SYSTEMS

§ 5. Rate Structure

Current System. The estate and gift taxes operate under a progressive, but highly compressed, rate system. In 2004, the rates range from 45 percent to 48 percent. After 2010, the highest marginal rate increases to 50 percent.[42] Under the EGTRRA, in 2006, progressivity disappears from the rate table. At that time, the estate tax applicable exclusion amount increases to $2 million and the highest marginal transfer tax rate decreases to 46 percent, which is the same rate that applies at the $2 million threshold.[43]

Accessions Tax. The tax could be imposed at a flat rate or under a rate schedule that progresses as the cumulative receipts increase.

Income-Inclusion System. No separate rate schedule is necessary. Congress could treat the receipts as any other income, or it could permit income averaging.

Deemed-Realization System. Under a deemed-realization system, presumably, the rates for capital gains would apply to net capital gains that result from gratuitous transfers.[44] Congress could allow all or some loss and deduction carryforwards to be taken into account at death on the decedent's final income tax return. It also could provide a separate rate schedule for taxable transfers taking place at death that result in ordinary income.

§ 6. Exemption Structure

Current System. In 2004, the first $1.5 million of cumulative taxable transfers are exempt at a decedent's death.[45]

Accessions Tax. Under an accessions tax, Congress could provide every transferee who is a taxpayer with a single lifetime exemption, which would apply to cumulative transfers. It could

[42] The estate tax applicable exclusion amount is $1.5 million in 2004. After 2010, the estate and gift tax applicable exclusion amount is $1 million, which means that the rate structure actually begins at 45 percent. IRC § 2010; EGTRRA § 901 (reinstatement of the wealth transfer tax system in effect in 2001). The highest marginal rate decreases to 48 percent in 2004 but returns to 50 percent after 2010. For a schedule of the estate and gift tax applicable exclusion amounts between 2001 and 2011, see Appendix B.

[43] IRC §§ 2001, 2010. In 2007, the highest marginal rate drops from 46 percent to 45 percent and remains at that rate through 2009.

[44] One issue Congress would need to resolve is whether to disallow some or all losses arising from lifetime gifts in accordance with IRC § 267, which disallows losses from sales or exchanges between related persons.

[45] The estate tax applicable exclusion amount increases to $3.5 million in 2009. IRC § 2010. The EGTRRA, however, limits the applicable exclusion amount for gifts to $1 million. IRC § 2505. For a schedule of the estate and gift tax applicable exclusion amounts between 2001 and 2011, see Appendix B.

treat a spouse as a separate transferee, with his or her own exemption. A trust would not be considered a taxpayer, unless Congress imposes a tax on large trusts.[46]

Income-Inclusion System. The income tax generally does not provide for source-based exclusions. Congress, however, could adopt a modest lifetime exclusion for receipts of gratuitous transfers under an income-inclusion system.

Deemed-Realization System. The income tax already provides rate reductions for net capital gains in various categories. Nevertheless, under a deemed-realization system, Congress could provide an exemption for *de minimis* transfers, such as gains and losses on low- to moderate-value tangible personal property. The deemed-realization system automatically excludes cash transfers. A lifetime exemption is not appropriate under the deemed-realization system, because it is not a transfer tax system. Rather, the deemed-realization system makes the income tax base more comprehensive. Nevertheless, Congress could provide a modest lifetime exemption, but the exemption should not be available for deferred compensation rights.[47]

§ 7. Special Rules for Lifetime Gifts

Current System. The gift tax is tax exclusive, which means that the gift tax is excluded from the gift tax base.[48] In addition, lifetime payments of another's tuition and medical costs are exempt without limitation.[49] Otherwise, lifetime transfers of present interests are exempt in the amount of $11,000 (adjusted for inflation) per donor, per donee, per year.[50]

Accessions Tax. The donee is liable for the tax on the amount of the gift received, and, therefore, the tax is tax inclusive.[51] Congress could incorporate rules that exclude certain gifts. One alternative would be to exempt all consumption-type gifts, including educational and medical costs, but not gifts representing durable property and investments, other than minor outright gifts of cash.[52] Gifts made in trust would not be excludable. Congress would need to adopt rules to prevent transferors from disguising wealth transfers as consumption-type gifts and using multiple nominal recipients as conduits for transfers to a single recipient.

Income-Inclusion System. As with an accessions tax, under the income-inclusion system, a donee is liable for the tax on the amount received, and, therefore, the tax is tax inclusive.[53] Under the income tax, an earner-spender generally is taxed for consumption, which means that a transferor does not receive a deduction for a gratuitous transfer. In this regard, the income-inclusion system is similar to an accessions tax. As with an accessions tax, Congress would need

[46] For a discussion of the treatment of trusts under an accessions tax, see *supra* § 2.
[47] For further discussion of deferred compensation rights, see § 9.A of the Report.
[48] For further discussion of the tax exclusivity of the gift tax, see § 20 of the Report.
[49] IRC § 2503(e).
[50] IRC § 2503(b). For further discussion of the problems that arise because of the current design of the annual exclusion, particularly with regard to time-limited withdrawal powers, and the tax exclusivity of the gift tax, see §§ 16 and 20 of the Report.
[51] Any payment of the donee's tax by a donor would be treated as an accession to the donee.
[52] *See* Dodge, *supra* note 20, at 551, 586–87.
[53] For further discussion of the tax exclusivity of the gift tax, see § 20 of the Report.

to address gratuitous transfers that a transferor attempts to disguise as a consumption transaction or gratuitous transfers made in trust for multiple nominal transferees that a transferor in fact intends for the benefit of a single individual.

Deemed-Realization System. Tax exclusivity is not an issue under a deemed-realization system, because the amount deemed to have been realized in the case of a gift is the asset's fair market value, unreduced by the deemed-realization tax.[54] Congress does not need to make any special exclusion rule for small gifts. Gifts of cash do not generate deemed gains or losses and, therefore, are not subject to taxation under the deemed-realization system. Also, the deemed-realization system generally does not apply to gifts of low- to moderate-value personal-use property, because they typically produce nondeductible losses. Appreciated collectibles should be subject to taxation under the deemed-realization system and need no special rule. Congress could treat a gain on a personal residence in accordance with IRC § 121, which excludes a gain of up to $250,000 on the sale of a personal residence, if the owner meets certain requirements.

§ 8. Effect of Structure on Transfer Patterns

The following discussion disregards issues concerning marital and charitable transfers. They are addressed later.[55]

Current System. In general, the amount of tax that the wealth transfer tax system imposes on a transferor is the same, regardless of the relative size of each transfer. The current law, therefore, is relatively neutral regarding transfer patterns.[56]

Accessions Tax. An accessions tax explicitly provides an incentive for the dispersal of transfers and the targeting of transfers to transferees who are in low rate brackets. This feature of the system raises the potential for abusive dispersal, although the problem of nominal transferees should not arise.[57] A number of solutions to this problem is available. Congress could:

a. treat transfers to the spouse of a family member as transfers to the family member;

b. treat nonconsumption transfers to a minor, or even an adult, as being made to the parent, if living, if the parent is related to the transferor;

c. disregard general lifetime powers of appointment in certain cases; or

d. limit exclusions to the issue of a living family member to consumption transfers.

Income-Inclusion System. Tax avoidance through multiple transfers to low-rate-bracket transferees also is an issue under the income-inclusion system. The transferor has the incentive to

[54] The same would be true of a bequest.
[55] *See infra* §§ 14, 15.
[56] For a discussion of valuation rules and how valuation rules favor lifetime transfers over deathtime transfers, see § 18 of the Report.
[57] An accession occurs only on actual receipt, which includes a distribution from a trust, and not on the creation of a contingent interest in a remote relative, and, therefore, the problem of nominal transferees is reduced.

target transfers to transferees who are in low rate brackets.[58] The “anticipatory assignment of income” doctrine is sufficient to deal with potential abuses.[59]

Deemed-Realization System. The deemed-realization system does not encourage transferors to make transfers to multiple transferees because it determines tax liability exclusively with respect to the transferor.[60]

§ 9. Equity Considerations

Equity in this context means the equal tax treatment of individuals who are similarly situated. The following discussion disregards generation-skipping transfers. They are addressed later.[61]

Current System. Under the current wealth transfer tax system, with its progressive tax rates, equal cumulative tax bases of transferors bear equal tax. The transfer tax base of a transferor is unrelated to any economic attributes of the transferees, who ultimately bear the burden of the tax. Thus, for example, the law treats the sole recipient of a $1 million estate more favorably than the recipient of one-fourth of a $4 million estate, and treats the sole recipient of a $4 million estate less favorably than the recipient of all of four separate $1 million estates.[62]

Accessions Tax. Under an accessions tax, transferees of the same aggregate taxable amount of gratuitous transfers bear the same tax on a lifetime basis. The rationale for this treatment is that a gratuitous receipt is a separate and unique kind of accession to wealth, distinguishable from other sources of income, including other “windfall” income.

Income-Inclusion System. The income-inclusion system treats gratuitous receipts the same as any other item of gross income. Under this premise, it assures that persons with the same net income bear the same tax on an annualized basis. The progressive tax rates under the income tax apply to an individual’s annual taxable income. A transferor can reduce the effect of the progressive tax rate on any large gratuitous transfer by arranging for the transfer to be made in installments. Alternatively, Congress could adopt an income-averaging rule.

[58] Accumulation trusts are generally in the highest rate bracket under the current income tax law. IRC § 1(e). There is also the “kiddie tax,” which has the effect of taxing unearned income of a minor at that child’s parent’s highest marginal rate. IRC § 1(g). Congress could extend the threshold of the kiddie tax beyond the current age of 14. IRC § 1(g)(2)(A).

[59] *See* JOSEPH M. DODGE ET AL., FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, POLICY 185–88, 205–13 (2d ed. 1999).

[60] The timing of transfers and the valuation placed on the amount realized could affect the amount of tax liability. In that regard, the deemed-realization system is sensitive to the size and number of transfers, although it is indifferent to the tax characteristics of the transferees. For further discussion of valuation issues, see § 18 of the Report.

State law could apportion the aggregate deemed-realization tax at death either to the beneficiaries of each deathtime transfer, based on the pretax value of the transferred property, or only to the residuary beneficiaries.

[61] *See infra* § 16. Whether a grandchild and a child are positioned equally is the subject of significant debate.

[62] For a similar discussion of the different tax consequences to recipients under the current transfer tax law, see § 18.A of the Report.

Deemed-Realization System. The deemed-realization system expands the income tax base to include gains on gratuitously transferred property. It prevents transferors from permanently avoiding tax on accrued, but unrealized, net gains. Thus, the deemed-realization system taxes a person who gratuitously transfers an appreciated asset the same as a person who sells or exchanges that asset. A rule that requires transferees to take a carryover basis in the assets they acquire through gratuitous transfers also assures that unrealized net gains do not permanently avoid income taxation. That rule would tax the transferee for appreciation accrued before that transferee receives the property. The deemed-realization system, however, taxes the transferor, who has both earned and controlled the disposition of that appreciation.[63]

§ 10. Valuation of Fractionalized, Temporal, and Contingent Interests

Current System. The current wealth transfer tax system, which requires a valuation at the time of a transfer, has to rely on actuarial tables to value temporal and some contingent interests. Some contingent interests are impossible to value.[64]

Accessions Tax. The amount subject to tax is the value of what the transferee receives and not what the transferor relinquished. Logic suggests that there be discounts for noncontrolling interests received, but Congress may want to take a different approach, such as the adoption of a family-attribution rule. Congress also could adapt its valuation rules to address discounts for fractionalizations of tangible personal property. An accessions tax does not need to rely on actuarial tables, because the taxable event does not occur until actual receipt of the property by the beneficiary. Thus, in the case of a trust, the taxable event is not the acquisition of property by the trust or the vesting of a beneficiary's equitable interest in the trust, but the possession by the beneficiary of income or corpus from the trust.

Income-Inclusion System. Under the income-inclusion system, principles similar to those governing an accessions tax apply, except that a trust is treated as a separate taxpayer. Therefore, when a transferor funds a trust, the amount transferred constitutes income to the trust. Subchapter J, having to do with the taxation of trusts, subsequently governs the tax treatment of income, gain, or loss in determining the tax liability of the trust and its beneficiaries.

Deemed-Realization System. The deemed-realization system treats a transferor as having realized the fair market value of the property that the transferor has transferred gratuitously. Therefore, the valuation of the amount realized should be based on the value of the property in the hands of the transferor, and not on the value of what the transferee receives.[65] The identity of the transferee is irrelevant. Consequently, the amount realized does not vary when a transferor makes a gift of the entire asset, regardless of whether the transferor makes a gift to more than

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[63] The current IRD rules are an exception to this principle. IRC §§ 691, 1014(c). Under a deemed-realization system, consistency would dictate treating IRD as a deemed-realization asset.

[64] For a discussion of the valuation issues that arise with respect to lifetime and deathtime transfers, see § 18.A of the Report.

[65] Congress is likely to deny recognition of accrued losses in accordance with IRC § 267, which denies losses for property sold to or exchanged by a taxpayer with family members.

one transferee of a fractional interest in an entity or in a unique item of tangible property.[66] It also does not vary if the transferor makes a gift of the entire asset, but creates temporal interests in that asset.[67] Discounts for fractionalized interests and actuarial valuation, however, still may be necessary when transferors do not transfer their entire interests in an entity or in property at the same time.[68] Congress could adopt valuation rules to address these types of transfers.[69]

§ 11. Tax Base and Timing Issues

The current wealth transfer tax system requires the determination of whether a transfer is a lifetime gift, which means the gift tax applies, or a deathtime transfer, which means the estate tax applies, or possibly both. Under an accessions tax or income-inclusion system, both of which are transferee oriented, the identity of the transferor generally is irrelevant, and gratuitous receipts can occur before, at, or even after the transferor's death. The discussion below does not address issues related to spouses. The consequences of marriage and generation-skipping transfers are addressed later.

A. Transfers with Retained Interests and Powers[70]

Current System. Under the current wealth transfer tax system, complex rules, which the courts have supplemented, address timing issues and the question of when a transfer is complete for tax purposes.[71] Properly or not, the estate and gift tax rules differ from the income tax rules dealing with the same issues, and the estate tax rules differ from the gift tax rules. In any case, use of actuarial tables may be necessary, because the wealth transfer tax system values property at the time of transfer, and not when the transferee receives possession of the property. It is possible for a transfer to be subject, in whole or in part, to both the estate tax and the gift tax, thereby necessitating a provision to mitigate the double taxation of transferred interests.[72]

[66] For further discussion of the valuation of interests in entities and unique items of tangible property, see § 18.A of the Report.
[67] For further discussion of temporal interests in property, see § 18.B of the Report.
[68] It is not clear that the tax law should allow basis to a person who transfers the balance of an income interest, because, if that person had received the remaining income stream, the tax law would not have allowed that person a basis.
[69] For further discussion of approaches to fractionalized interests and temporal interests, see § 18 of the Report.
[70] These are sometimes referred to as "hybrid" or "string" transfers.
[71] *See* IRC §§ 2036–2038. For further discussion of these provisions, see § 23.A of the Report. If the transferor sells the property, rather than gives it away, the inclusion provisions of IRC §§ 2036–2038 do not apply.
[72] *See* IRC § 2001(b).

Accessions Tax. An accessions tax assesses a tax on transferees. Normally, therefore, it is not necessary to determine when a transferor makes a completed transfer to a trust. Under an accessions tax, a trust is not treated as a separate taxpayer, except to the extent required to prevent the deferral of tax on unreasonable accumulations of wealth.[73]

Under an accessions tax, the acquisition of a trust interest by an individual is not treated as an accession. Trust distributions, whether of income or corpus, do constitute accessions.[74] The deferral of the tax is not a significant concern, because the aggregate tax base attributable to a transfer made in trust grows with the passage of time.[75]

Congress could address a successive-interest transfer of personal-use property held outside of a trust in either of the following ways:

i. treat the transfer as if it were a trust, which would mean that the law would impute (based on fair rental value) and tax as accessions annual distributions to the holder of the life or term interest, and would tax the remainder interest as an accession when the owner comes into possession of it; or

ii. treat the acquisition of the term interest as an accession at its actuarial value,[76] and tax the remainder interest as an accession when the owner comes into possession of it.[77]

Income-Inclusion System. Under an income-inclusion system, the treatment of transfers of property to trusts requires consideration of the rules that pertain to the income taxation of trusts. One alternative would be for Congress to follow an accessions tax approach and not tax

[73] If an accessions tax imposes a tax on a trust in the case of a large transfer, issues of whether a transfer is complete could arise. *See supra* § 2. Those issues, however, would be much less complex than they are under the current transfer tax system. Presumably, only a transfer subject to retained rights or powers equivalent to a presently exercisable general power of appointment would constitute an incomplete transfer. If a transfer is incomplete, it would not be subject to an accessions tax for a large transfer made to a trust until the retained rights or powers terminated or the transferor relinquished them.

[74] It seems proper that the income tax attributable to an income distribution should reduce the amount of the taxable accession.

[75] Large trusts may not have this deferral available. *See supra* § 2.

At least one commentator has suggested that the system mitigate the effect of an enlarged tax base under a progressive rate system. *See* Halbach, *supra* note 20, *supra*, at 248–60. This suggestion, however, assumes that the "norm" is that a transfer should be valued when made, as it would be under an estate or gift tax, but an accessions tax is built on a different basic concept, namely, taxation upon receipt. Moreover, the effect of progressive rates can be counteracted by dispersal among numerous transferees, each with his or her own lifetime exemption. Finally, if an accessions tax otherwise lacks a generation-skipping feature, the enlargement of the tax base over time might dampen what otherwise is perceived to be a deferral advantage of creating dynastic trusts.

[76] If the holder of the term interest has the power to consume the property or make a sale or gift of it, an accessions tax should treat that person as having received the entire property.

[77] A question arises whether a purchase for the value of a remainder interest would result in exclusion of the subsequent remainder distribution from an accessions tax. That type of transaction should not preclude application of an accessions tax, because the purchase of a remainder interest by a related party serves no business or commercial function, and likely would be tax motivated. An accessions tax, however, could exclude from taxation the amount the buyer actually paid for the remainder. An accessions tax also could treat the amount received by the seller of the remainder interest as an accession.

property that a transferor transfers to fund a trust, unless and until a trustee distributes it.[78] On the other hand, the income tax law treats a trust as a separate taxpayer. Moreover, under an income tax, a taxpayer generally makes investments (and a trust can be viewed as an investor) with previously taxed dollars. If Congress were to treat a trust as a taxpayer for the purpose of the income-inclusion system, it would:

i. treat a completed transfer of property to a trust as current income to the trust, and the trust would acquire a basis equal to the amount it includes in income;

ii. tax current trust income to the transferor, the trust, or the distributees according to the current income tax rules; and

iii. not tax nonincome distributions to the distributees.

Yet another alternative would be for Congress to treat the tax on the property that a transferor gratuitously transfers as a withholding tax, so that distributions of corpus, increased by the amount of tax paid, would be income to the distributees, who, in turn, would obtain a credit equal to the amount of tax previously paid.[79] Under either approach that views the trust as a separate taxpayer, Congress still must determine when a lifetime transfer becomes complete. The consequence of a transferor's making a completed transfer would be that the transferor no longer is subject to tax on the income from the property transferred, and the trust or the distributees, as the case may be, would be subject to the income tax.

As for nontrust transfers of personal-use property, the income tax generally ignores imputed income. If the income-inclusion system is viewed as being a form of a wealth transfer tax, a logical alternative would be to recognize imputed income for personal use, although this approach, while closing a potentially major loophole, may give rise to administrative and valuation difficulties. If Congress were to recognize imputed income in this situation, the gross income of a person acquiring a life or term interest would be based on the actuarial value of that interest, and the person acquiring the remainder interest would include the full value of the property in income when that person comes into possession of it.[80]

Deemed-Realization System. Under a deemed-realization system, the question of when a transfer is complete has to be determined on an all-or-nothing basis. Presumably, Congress would treat a transfer as incomplete only so long as the transferor retains the functional

[78] If Congress were to adopt this option, it should subject transfers to a trust either to a deemed-realization rule or a carryover basis rule, without any exemptions or exclusions.

[79] The credit should not bear interest because the tax on the trust was not a "prepayment." The purpose of the tax-and-credit option is only to get the marginal rates "right" based on hindsight, i.e., included in the income of the ultimate recipient. Congress could extend the tax-and-credit option to accumulated income, but that greatly would complicate the system and essentially would result in adoption of the now-rejected throwback rules. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 507, 111 Stat. 788, 856 (1997) (repealing the throwback rules).

[80] Under this approach, the holder of the life or term interest would have a wasting asset with a basis equal to the amount included. However, present IRC § 167(e) prevents the amortization of a life or term interest when the remainder interest is held by a related party.

In contrast to the tax-saving incentives under an accessions tax, the purchase of a remainder interest under the income-inclusion system would not lead to tax savings, because it would give the purchaser a basis in remainder distributions equal only to the purchase price.

equivalent of a presently exercisable general power of appointment.[81] Double taxation cannot occur under a deemed-realization system, because each deemed-realization event establishes a new basis equal to the asset's fair market value.[82]

B. Jointly Owned Property

Jointly owned property has been viewed as a subcategory of transfers subject to a transferor's continuing enjoyment or control, because the individual who provides consideration in the acquisition and improvement of jointly owned property retains interests and powers over the property.

Current System. Current transfer tax law treats property jointly owned by persons other than spouses as retained-interest transfers by the transferor. The difficulty arises in identifying the transferor.[83] For gift tax purposes, the creation of jointly owned property is treated as a completed transfer to the extent the transferor receives an interest in the property that is less than the percentage of consideration the transferor provided, unless the transferor retains the right to regain the interest in the transferred property.[84] For estate tax purposes, IRC § 2040(a) generally provides that the amount subject to tax is the excess, if any, of the fair market value of the property acquired by the survivor less the fair market value of the percentage of consideration that the survivor provided in the acquisition and improvement of the property.[85] Although jointly owned property held by spouses essentially is untaxed due to the unlimited marital deduction, IRC § 2040(b) adopts a special rule for spouses that includes one-half of the value of that jointly owned property in the estate of the first spouse to die.[86]

Accessions Tax. Under an accessions tax, Congress could ignore the creation of jointly owned property and, instead, treat the severance of a joint tenancy as a taxable event. It also could treat the death of a joint tenant as a taxable event. The amount subject to an accessions tax, whether upon severance or death, would be the excess, if any, of the fair market value of the property acquired by the recipient less the fair market value of the percentage of consideration that the recipient provided in the acquisition and improvement of the property. Under this approach, an accessions tax would be adopting a rule analogous to the one found in IRC § 2040(a). Congress also could adopt a rule that is analogous to the one found in IRC § 2040(b) and treat a surviving spouse as having purchased half of the jointly owned property held exclusively by the spouses.

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[81] Although the taxation of a transfer subject to a retained interest of income or enjoyment could be deferred until the interest expires, there is no logical inconsistency in treating the initial transfer as a realization event and treating the transferor as the continuing owner of the income for income tax purposes.
[82] *See supra* § 4.
[83] IRC § 2040(a).
[84] Treas. Reg. § 25.2511-1(h) (Exs. 4, 5).
[85] IRC § 2040(a) addresses situations in which the joint tenants acquire property by gift or inheritance.
[86] For further discussion of problems with jointly owned property under the current tax system, see § 23.C of the Report.

Income-Inclusion System. For property jointly owned by nonspouses, the income tax law treats any consideration that a joint tenant supplies as that joint tenant's basis in the property. At the death of the first joint tenant, the income-inclusion system treats the surviving tenant as having received the fraction of the property attributable to the other party's investment. The survivor does not have to realize any income on the survivor's own share in the jointly owned property. The following examples illustrate the treatment of jointly owned property under the income-inclusion system.

> *Example 1: Unequal contributions by the joint tenants and the jointly owned property terminates upon death*. *A* provides $40,000 and *B* provides $10,000 of consideration for the purchase of *Blackacre,* which *A* and *B* acquire as joint tenants with right of survivorship. At the time of *A*'s death, the fair market value of *Blackacre* is $100,000. The income-inclusion system treats *B* as having received income of $80,000 ([$40,000 ÷ $50,000 ($40,000 + $10,000)] x $100,000). *B*'s basis in *Blackacre* after *A*'s death is $90,000 ($10,000 + $80,000).
>
> If *B* had died first, the income-inclusion system would have treated *A* as having received income of $20,000 ([$10,000 ÷ $50,000 ($40,000 + $10,000)] x $100,000). *A*'s basis in *Blackacre* after *B*'s death would have been $60,000 ($40,000 + $20,000).

> *Example 2: Unequal contributions by the joint tenants and the joint tenants sever the joint tenancy.* The facts are the same as in example 1, except that *A* and *B* sever the joint tenancy before one of them dies. At the time of the severance, *Blackacre* has a fair market value of $100,000. *A* and *B* each receive one-half of *Blackacre*, valued at $50,000 each. Under the income-inclusion system, *A* realizes no income upon the severance. *A*'s basis in her one-half interest in *Blackacre* is $25,000.[87] *B* realizes income of $30,000 and has a basis in her half of *Blackacre* of $40,000 ($10,000 + $30,000).[88]

For jointly owned property held by spouses, under the income-inclusion system, the surviving spouse does not realize any income at the death of the first spouse. The surviving spouse acquires a basis in the property equal to the spouses' combined bases in the property. If the spouses sever the joint tenancy during life, neither would realize any income at the time of the severance, regardless of their respective contributions to the acquisition or improvement of the property. Each would take a basis in the property equal to one-half the amount of their combined bases in the property

Deemed-Realization System. For property jointly owned by nonspouses, under the deemed-realization system, the death of the first tenant is treated as a deemed sale of that fraction of the property that constitutes the decedent joint tenant's contribution to the acquisition or improvement of the property. If the tenants sever the joint tenancy during life, the severance is treated as a deemed sale to the extent that one of the joint tenants receives less than the fraction of the property that constitutes that joint tenant's contribution to the acquisition or improvement of the property. For jointly owned property held by spouses, the death of one spouse is not considered a realization event. The surviving spouse acquires a basis equal to the spouses' combined bases in the property. A severance of the joint tenancy by the spouses also is not

[87] Before the severance, the income-inclusion system treats *A* as having owned all of her half, which has a basis of $25,000, and 60 percent or $15,000 of *B*'s half, which *B* now owns after the severance.

[88] Before the severance, the income-inclusion system treats *B* as owning no part of *A*'s half and as having paid $10,000 for a 20 percent interest in *Blackacre.* After the severance, *B*'s interest in *Blackacre* increases to 50 percent, which is an increase in value of $30,000 ((50 percent – 20 percent) x $100,000).

considered a realization event, regardless of the respective contributions of the spouses to the acquisition or improvement of the property. Each spouse would take a basis in the property equal to one-half the amount of the spouses' combined bases in the property.

C. Annuities

Current System. The current wealth transfer tax system generally treats commercial annuities with a survivorship feature as retained-interest transfers.[89] Private annuities generally are treated as sales for value.

Accessions Tax. An accessions tax treats payments under a commercial annuity as an accession when a person other than the purchaser receives them. It likely would treat a private annuity as a purchase of property. If the value of the annuity given in exchange for property is less than the fair market value of the property, the difference is treated as a taxable accession to the purchaser.[90]

Income-Inclusion System. The income tax law currently treats commercial annuities as deferred IRD, and the recipients take a carryover basis in the annuity.[91] Congress could accelerate the taxable event and give the survivor annuitant a basis equal to the annuity's fair market value. As for private annuities, the general principles of the income tax law determine the tax consequences for the seller. For the buyer, the income-inclusion system could treat a private annuity in the same manner that an accessions tax would treat it.

Deemed-Realization System. The deemed-realization system treats payments under a commercial annuity to a person other than the purchaser as a realization event.[92] Private annuity transactions are considered actual sales, and the deemed-realization rule plays no role.

[89] IRC § 2039. For a discussion of the current wealth transfer tax system's treatment of annuities, see § 23.B of the Report.

Under community property laws, annuities, employee survivor benefits, and life insurance may be treated as owned equally by the husband and wife for transfer tax purposes.

[90] Congress could avoid relying on actuarial tables that are subject to tax minimization strategies and treat the purchase transaction as incomplete for accessions tax purposes until the annuity expires.

[91] IRC §§ 691, 1014(c).

[92] Annuities, treated as IRD under current law, receive less favorable treatment than other assets. Under a deemed-realization system, annuities and other IRD would receive the same income tax treatment as other assets.

D. Employee Survivor Benefits

Current System. The current wealth transfer tax system generally includes employee survivor benefits in the decedent's gross estate.[93] It is easy, however, to avoid inclusion of survivor benefits paid by employers that are not part of an employee's qualified retirement plans.[94] The gift tax treatment of employee survivor benefits is unsettled.[95]

Accessions Tax. An accessions tax treats employee survivor benefits as a taxable accession when the survivor receives them. It ignores purported completed gifts by employees during life.

Income-Inclusion System. The income-inclusion system includes the value of employee survivor benefits in the gross income of the survivor. The value of the survivor benefits establishes the recoverable basis under IRC § 72.

Deemed-Realization System. Under the deemed-realization system, unless compensation from a qualified arrangement warrants deferral beyond an employee's death, the death of the employee is treated as a realization event.

E. Powers of Appointment

A general power of appointment is either a presently exercisable power to obtain property for oneself or for one's creditors, or a testamentary power to vest the property in one's estate or in the creditors of one's estate.[96] A general power of appointment usually pertains to property held in trust.

Current System. The current estate tax law includes property over which a decedent owns a general power of appointment at death in the decedent's gross estate.[97] The current gift tax law generally treats a lapse, release, or exercise of a general power of appointment as a taxable transfer.[98]

[93] *See* Rev. Rul. 65-217, 1965-2 C.B. 214.
[94] *See, e.g.*, Estate of Tully v. United States, 528 F.2d 1401 (Ct. Cl. 1976); Bogley's Estate v. United States, 514 F.2d 1027 (Ct. Cl. 1975).
[95] *See* Estate of Levin v. Commissioner, 90 T.C. 723 (1988) (rejecting the government's argument that the employee made a lifetime gift, but holding the survivor benefit includable in the employee's gross estate under IRC § 2038(a)(1), because the employee was also a controlling shareholder); Estate of DiMarco v. Commissioner, 87 T.C. 653 (1986) (rejecting the government's argument that the employee made a gift of the survivor benefit during life, but that the gift was not taxable until the employee died).
[96] *See* IRC §§ 2041(b)(1), 2514(c).
[97] IRC § 2041(a)(2).
[98] IRC § 2514(e) makes an exception for lapse of powers to the extent that the property that could have been appointed does not exceed the greater of $5,000 or 5 percent of the value of the trust. Also, a lifetime exercise of a general power of appointment is not treated as a taxable gift to the extent that the donee retains the right to revoke the exercise of the power or otherwise retains the beneficial or nonbeneficial right to change the appointment. *Cf.* Treas. Reg. § 25.2511-2.

Accessions Tax. Under an accessions tax, no significance attaches to testamentary powers of appointment.[99] As for presently exercisable general powers of appointment, the holder acquires an accession when the power becomes presently and solely exercisable in all events.[100] Trust distributions on termination or otherwise are taxable accessions, regardless of powers, unless an accessions tax had been imposed earlier because a recipient of a distribution had held a presently exercisable general power of appointment.[101]

Income-Inclusion System. The income tax law attributes income to the person who has control over that income through a presently exercisable general power of appointment, regardless of who receives that income. The logic of an income-inclusion system would seem to dictate that income be attributed both to the holder of the presently exercisable general power of appointment and to the trust or distributee. As the recipient of the gift of the income from the power holder, the trust or the distributee is subject to the income tax. If Congress views that result as harsh, it could adopt a variety of mechanisms to mitigate it.[102]

[99] Even when the identity of the transferor is relevant, for example for transfers between spouses or for generation-skipping transfers, there is no opportunity to avoid tax through the creation of a testamentary general power of appointment.

[100] An accessions tax could limit the use of general powers of appointment to transferees in low rate brackets through a GST tax and through rules that address the use of trusts for multiple nominal transferees that a transferor in fact intends for the benefit of a single individual. A possible concern may be that transferors could use the rule that treats the acquisition of a presently exercisable general power of appointment to accelerate the accession event when the holder of the power is the sole, or principal, beneficiary of a trust. The current tax treatment of time-limited withdrawal powers may need to be reexamined in the context of an accessions tax. For further discussion of time-limited withdrawal powers, see § 16 of the Report.

[101] If the holder of a presently exercisable general power of appointment is the sole beneficiary of a trust, the creation of the power may appear to be a device to accelerate tax. Congress, however, is likely to treat the creation of a trust for a single beneficiary as a taxable accession to that beneficiary of the entire corpus of the trust, regardless of whether that beneficiary owns a power.

[102] Thus, if accumulated income is attributed to both the holder of the presently exercisable general power of appointment and the trust, and the trustee later distributes it to the holder of the power, the latter should be able to exclude the distributions from income to the extent they were previously taxed. In the case of distributions of current income to a person other than the holder of the power, Congress has available various options to assure that the income is taxed only once. Congress could:

i. attribute the income only to the holder of the power, if the holder is over 18 and not adjudged to be incompetent;
ii. attribute the income only to the distributee; or
iii. attribute the income to whichever person is in the highest rate bracket.

Deemed-Realization System. Deemed-realization events can occur while property is held in trust. For example, Congress may deem trust assets to be sold and repurchased by the trust at periodic intervals to discourage long-term trusts.[103] In-kind distributions from an ongoing trust or upon trust termination also can result in a deemed realization. Congress would not need to attribute the gains from a deemed realization to a taxpayer other than the trust, except when the property is not distributed to a holder of a presently exercisable general power of appointment.[104]

F. Life Insurance

The wealth transfer taxation and the income taxation of life insurance are problematic because they both require a determination of the relationship between premium payments and proceeds. In addition, the distinction between insured-owned and beneficiary-owned life insurance is difficult to establish, because the insured usually is involved in the procurement of the policy, regardless of who owns it.

Current System. The current estate tax law includes life insurance in the gross estate of the insured, if the insured has retained incidents of ownership or the proceeds are payable to the insured's estate.[105] If an insured relinquishes all incidents of ownership over a life insurance policy, it is excluded from the insured's estate, even though the insured may have continued to pay the premiums on the policy.[106]

Accessions Tax. An accessions tax treats the amount of life insurance proceeds that a taxpayer receives as an accession, regardless of who owned the policy, except to the extent of the amount of premiums the recipient paid and any amount, with respect to the same policy, previously treated as an accession to the recipient.[107] Incidents of ownership are irrelevant.

Income-Inclusion System. The income-inclusion system treats the life insurance proceeds, less any basis the recipient may have in the policy, as income to the recipient, whether the recipient is an individual or a trust. Incidents of ownership are irrelevant.

Deemed-Realization System. Under the deemed-realization system, the receipt of proceeds by a person other than the owner of the life insurance is considered a realization event, and not a deemed-realization event, because it represents an exchange of the recipient's right to

[103] *See supra* § 4.

[104] The following example illustrates the treatment of a general power of appointment under a deemed-realization system.

> *Example: Distribution from a trust to a person other than the holder of a power. G* establishes a trust that gives *A* a presently exercisable general power of appointment over the trust corpus. If the trustee distributes a portion of the trust corpus to *A*, the distribution could, but need not, be treated as a realization event to the trust. If, however, the trustee distributes a portion of the trust corpus to *B*, the distribution should constitute a realization event to *A*.

[105] IRC § 2042.

[106] Treas. Reg. § 20.2042-1(c)(1).

[107] For income tax purposes, amounts received in excess of a transferee's basis could (and, like any other return on investment, probably should) be treated as taxable income.

the insurance proceeds for the proceeds themselves. The gain is attributable to the person who owned the policy immediately before the insured's death.

§ 12. Special-Benefit Assets

The term "special-benefit asset" refers to property, such as a closely held business interest or family farm, that Congress believes warrants favorable tax treatment, which often requires adoption of extensive qualification rules.

Current System. The current estate tax law has special valuation rules for farm and small-business real property and for certain real property subject to conservation easements.[108] In addition, it has provided an estate tax deduction for the value of certain family-owned businesses.[109] To assist estates that may be illiquid, the estate tax law also provides for an extension of time for the payment of estate taxes attributable to a closely held business.[110]

Accessions Tax. Under an accessions tax, Congress could provide tax relief for property that it believes warrants favorable tax treatment by deferring the taxable event for a special-benefit asset until the time that the recipient sells the asset or otherwise ceases to hold it for a qualifying use. Congress also could place some limits on the length of deferral.[111] In addition, Congress could take into account the economic benefits of deferral in the amount of tax it imposes upon disposition.[112]

Income-Inclusion System. Under the income-inclusion system, Congress could provide tax relief to property that it believes warrants favorable tax treatment in a manner that achieves results similar to those suggested for an accessions tax. It could exclude the special-benefit assets from income, but assign to them a zero basis, pending sale or cessation of a qualified use, which would be a deemed-realization event. Congress also could place a limit on the length of the deferral and make an adjustment for the time value of money.[113]

[108] IRC §§ 2031(c), 2032A.
[109] IRC § 2057. The EGTRRA repealed this provision for decedents dying after 2003. IRC § 2057(j). The EGTRRA, however, reinstates IRC § 2057 after 2010. EGTRRA § 901. For a discussion of IRC § 2057, see § 26 of the Report.
[110] IRC § 6166. For a discussion of IRC § 6166, see § 25 of the Report.
[111] Congress could place some time limit on the deferral to prevent multiple generations from holding property without sale.
[112] Alternatively, Congress could impose an interest charge, make an adjustment reducing basis, perhaps even below zero, or adopt other rules that take into account the value of deferral.
[113] *See supra* text following note 32.

Deemed-Realization System. Under the deemed-realization system, Congress could provide tax relief to property that it believes warrants favorable tax treatment in a manner that achieves results similar to those suggested for an accessions tax. It could treat the transfer of a special-benefit asset as a nonrealization event. Instead, Congress could require that the transferee take the transferor's basis. Cessation of qualified use would be treated as a realization event. Congress also could place limitations on the duration of the deferral and make an adjustment for the time value of money.[114]

§ 13. Costs of Wealth Transmission

A. Debts and Claims

The following discussion concerns debts of, and claims against, a decedent that arise before the decedent's death.

Current System. Debts and claims, including income tax liabilities, are deductible for estate tax purposes to the extent actually paid.[115] They are deductible for income tax purposes only if they qualify as deductions in respect of a decedent under IRC § 691(b).

Accessions Tax. Under an accessions tax, debts and claims paid by an estate or trust are not included as an accession. The value of claims and liens on transferred property, including income tax liabilities, reduces the accession amount with respect to that property.

Income-Inclusion System. Under an income-inclusion system, debts and claims paid by an estate, trust, or distributee are deductible to determine adjusted gross income under IRC § 62, i.e., they are deductible "above the line." Any income tax attributable to the inclusion of a gratuitous transfer in the recipient's income is not deductible.

Deemed-Realization System. The deemed-realization system treats debts and claims payable by the estate as having been paid by the decedent. The deductibility of the deemed payment on the decedent's final income tax return is treated as if the decedent were still alive. If a transferee of property assumes a debt or claim, the deemed amount realized should be the greater of the property's fair market value or the amount of the debt or claim.

B. Administration Expenses

Unlike debts and claims, administration expenses arise after death, suggesting that any tax benefits should accrue to the estate or the beneficiaries of the estate, rather than to the transferor.

Current System. The current tax law allows an estate to elect to deduct administration expenses for estate tax purposes or income tax purposes, but not both.[116]

[114] *See supra* text preceding note 40.
[115] IRC § 2053(a)(3), (c).
[116] IRC § 642(g).

Accessions Tax. Estate income augments legacies and is subject to both income tax and accessions tax. If an accessions tax values an accession at the time the legatee receives it, rather than at the time of the decedent's death, administration expenses reduce the amount of cash accession. As a rule of accounting convenience, Congress could allow an income tax deduction for administration expenses to the estate, trust, or legatee, as the case may be.[117]

Income-Inclusion System. Under an income-inclusion system, postdeath estate income augments legacies and estate administration expenses reduce them.[118] Therefore, there is no need to treat estates as taxable entities.[119]

Deemed-Realization System. Under the deemed-realization system, the decedent's death is considered the realization event. Postdeath outlays, therefore, do not reduce the amount realized by the decedent on appreciated assets. Under the assumption that Congress would repeal the estate tax if it enacts a deemed-realization system, administration expenses would be deductible only for estate income tax purposes.

C. Funeral Expenses

Funeral expenses are personal and do not relate to estate assets or income.

Current System. Current tax law allows the deduction of funeral expenses only for estate tax purposes.[120]

Accessions Tax. Under an accessions tax, funeral expenses paid by an estate reduce the amount of taxable accessions. The expenses are not deductible for income tax purposes.

Income-Inclusion System. Under the income-inclusion system, as is true under an accessions tax, funeral expenses paid by an estate reduce taxable receipts. Funeral expenses paid by an individual should be deductible as a nondiscretionary expense, possibly subject to a ceiling.[121]

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[117] Conceptually, administration expenses are costs of obtaining the legacies and, therefore, should be capitalized. The benefits of capitalization of the expenses, however, may not warrant the administrative effort.

[118] If an estate remains a taxable entity, Congress should not tax both the estate and the legatees on postdeath income. It could treat the estate income tax on accumulated income as a withholding tax, pending subsequent distribution. The subsequent distribution of accumulated income would include the amount of tax paid. Yet another alternative is that Congress could tax the income to the estate and treat distributions of accumulated income as tax-free corpus, rather than taxable corpus.

[119] The following example illustrates that if Congress were to treat an estate as a taxable entity, it would complicate matters unnecessarily.

> *Example: Estate with postdeath income and administration expenses. G* dies leaving a probate estate of $100,000. During year 1, the estate has income of $10,000 and administration expenses of $40,000. The executor distributes the net amount of $70,000 to the sole legatee at the beginning of year 2. Under the income-inclusion system, the legatee reports the net amount of $70,000 as income.

[120] IRC § 2053(a)(1).

[121] *See* 3 REPORT OF THE ROYAL COMMISSION ON TAXATION 1–24 (1966) (Can.).

Deemed-Realization System. In accordance with income tax principles, Congress could disallow a deduction for funeral expenses because those expenditures are unrelated to the deemed amount realized.

§ 14. Marital Transfers

The following discussion assumes that spouses are separate taxpayers, each with his or her own transfer tax exemption, if applicable.

Current System. The current wealth transfer tax law provides an unlimited estate and gift tax marital deduction.[122] Congress designed the qualification rules to assure that the surviving spouse's gross estate includes the property that the estate of the first spouse to die deducted as a marital deduction.[123] The overall effect of the marital deduction rules is that the aggregate wealth of the spouses, in excess of the spouses' applicable exclusion amounts, is subject to transfer tax at least once. Spouses must engage in careful estate planning to assure that their aggregate wealth is not taxed more than once and that they make optimal use of each spouse's applicable exclusion amount.[124] In addition to the marital deduction rules, IRC § 2513 permits spouses to elect to treat gifts made by one spouse to persons other than the other spouse as made one-half by the donor spouse and one-half by the nondonor spouse. This is known as the "split-gifts" rule.

Accessions Tax. Congress could provide for an unlimited marital exclusion for any receipt from a transferee's spouse under an accessions tax. An unlimited marital exclusion under an accessions tax would operate differently than the marital deduction under the current transfer tax system, because it would accomplish more than deferral and the full use of two applicable exclusion amounts. If Congress determines that an unlimited marital exclusion is unacceptable, it could permit, instead, an unlimited spousal gift exclusion combined with an estate exclusion limited to one-half of the aggregate spousal wealth.[125] The primary disadvantage of this option, however, is its complexity.

Elaborate qualification rules, such as for contingent interests, are unnecessary, since an accessions tax treats an accession as occurring only when the recipient comes into possession of the cash or property. If Congress places a limitation on the marital exclusion, however, it would have to calculate that limitation at the time of the death of the first spouse. This would create a problem for delayed transfers, such as transfers made to a trust. One possible solution is for Congress to treat actual distributions and payouts to the surviving spouse as being tax free until the accumulated value of the distributions to that spouse exceeds the result of multiplying:

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[122] IRC §§ 2056, 2523.

[123] It also assures that the transferee spouse's estate includes property received from the transferor spouse during life that the transferor spouse deducted under the gift tax marital deduction. Further, it assures that the transferee spouse incurs a gift tax when transferring property acquired from the transferor spouse for which the transferor spouse or the transferor spouse's estate took a marital deduction.

[124] For further discussion of estate planning for married couples, see §§ 2 and 17 of the Report.

[125] Congress would need to assure that transferors do not use the unlimited spousal gift exclusion to subvert the limited spousal deathtime exclusion.

i. the current value of the trust plus the total value of prior distributions by

ii. 1 minus a fraction that has as its numerator the amount of the exclusion and as its denominator the initial value of the trust.

Alternatively, Congress could restrict the spousal deathtime exclusion to a qualifying trust, which would include a trust over which a transferee spouse holds a general power of appointment, holds interests that meet the requirements of a qualified terminable interest property trust, or holds interests that meet the requirements of an estate trust.[126] If a transferor creates a qualifying trust, an accessions tax would not apply until the transferee spouse's interests in the trust terminate.

A related issue is how to treat accessions received by a spouse from a third party. One alternative is that Congress could allow the spouses to elect to split receipts from any third party, regardless of the identity of the transferor.[127] Another is that Congress could treat receipts from a family member of either spouse as accessions received by the spouse who is related to the transferor. This alternative would prevent strategies that would seek to make gifts to the spouse who is in the lowest rate bracket or has the most available exemption amount.

If an accessions tax includes a provision that taxes a trust upon its receipt of assets that exceed a designated threshold amount, accommodation for a marital exclusion is necessary.[128] If a trust is a qualifying trust, no accessions tax would be assessed until the transferee spouse's interests in the trust terminate, regardless of the size of the trust. At the termination of the transferee spouse's interests, an accessions tax may apply if the value of the trust corpus exceeds the designated threshold amount. If a trust is not a qualifying trust and the trust receives assets that exceed the designated threshold amount, an accessions tax would be assessed at the time of receipt. An accessions tax would not be assessed, however, on distributions to the transferee spouse from that trust to the extent that the distributions do not exceed the amount of the marital exclusion.

Income-Inclusion System. As with an accessions tax, under the income-inclusion system, qualification is simple, because it is tied to the actual receipt of cash or in-kind property. Also, as is true of an accessions tax, a marital exclusion leads to tax forgiveness and not just tax deferral. Further, as is true for an accessions tax, Congress could establish qualification rules for spousal-beneficiary trusts and exclude from income transfers made to those trusts until the transferee spouse's interests terminate.

Deemed-Realization System. Under a deemed-realization system, Congress could exempt qualifying transfers from deemed-realization treatment and require the transferee spouse to take a carryover basis. This approach parallels the treatment of lifetime interspousal gifts under IRC §§ 1041 and 2523. As is true with the current wealth transfer tax system, qualification must be *ex ante.* Under a deemed-realization system, however, cessation of qualification (i.e., the

[126] IRC § 2056(b)(5), (7); Treas. Reg. § 20.2056(b)-1(g) (Ex. 8), (c)-2(b)(1)(i), (2)(i); Rev. Rul. 68-554, 1968-2 C.B. 412.

[127] A mandatory accession-splitting rule would be well matched with a limited estate exclusion.

[128] *See supra* § 2.

transferee spouse's death or the termination of that spouse's qualifying interests) would be treated as a realization event, with any income tax liability being assessed against the property.

§ 15. Charitable Transfers

Charities are tax-exempt organizations for income tax purposes.[129] Charitable contributions, with some exceptions for split-interest transfers, generally are deductible under the income tax law.[130]

Current System. A transferor of temporal interests, which require reliance on actuarial tables to determine their value, can obtain a deduction for estate, gift, and income tax purposes so long as the transferor adheres to statutory qualification rules.[131]

Accessions Tax. Under an accessions tax, accessions by charities, outright or by means of trust distributions, are not subject to tax.[132] No actuarial valuation is necessary. The income tax law addresses the income tax deduction issues that arise.

Income-Inclusion System. A charity is exempt from income tax under IRC § 501(c)(3), and, therefore, a transfer to a charity does not result in taxation under the income-inclusion system. The income tax law addresses issues relating to transfers to charities of temporal interests.

Deemed-Realization System. Since the deemed-realization system taxes gains to a transferor, who, effectively, is deemed to have sold and then transferred the proceeds, Congress logically could treat the outright transfer of property to a charity as a realization event. However, Congress could choose to treat such an outright transfer as a nonrealization event to protect the charity from any tax burden. If an outright transfer of property to a charity is treated as a nonrealization event, then the same approach can be carried over to a split-interest charitable transfer. That is, the "passing" (the creation of a trust or the shifting of an interest held in trust) to a noncharitable beneficiary would be treated as a realization event, and the passing to a charitable beneficiary would be treated as a nonrealization event.

Current law could govern the income tax treatment of split-interest charitable transfers. For example, if a transferor establishes a charitable remainder annuity trust (CRAT) during life, the creation of that trust would be treated as a realization event. The transferor would be eligible for an income tax charitable deduction equal to the present value of the charitable remainder. It would not be a realization event when a charity, as the remainder beneficiary, comes into possession of the property. In contrast, in the case of a charitable lead annuity trust (CLAT), the creation of that trust would not be treated as a realization event. It would be a realization event when the noncharitable remainder beneficiary comes into possession of the property. This

[129] IRC § 501(c)(3).
[130] IRC § 170.
[131] *See* IRC §§ 642(c)(5), 664(d)(1)–(3), 2055(e).
[132] Congress may make trusts that receive property in excess of a designated threshold amount subject to an initial tax. *See supra* § 2. If an accessions tax imposes a tax on a trust, a distribution to a charity would not be treated as an accession by the charity, and, therefore, the distribution would generate a refundable credit to that charity.

treatment of a CLAT would require maintaining records of the transferor's basis and appropriate adjustments to it up until the time that the noncharitable remainder beneficiary takes possession of the property.

§ 16. Generation-Skipping Transfers

Current System. The GST tax law imposes a tax, at a flat rate, on generation-skipping transfers, both trust and nontrust transfers.[133] It provides a GST exemption to each transferor, which in 2004 is equal to $1.5 million.[134] It treats outright gifts and bequests to persons who are assigned to a generation that is two or more generations below the transferor as generation-skipping transfers. These generation-skipping transfers, referred to as direct skips, result in the taxation of gifts and bequests to grandchildren, great-grandchildren, and other members of remote generations.[135] The appropriateness of a GST tax on direct-skip-type transfers is controversial.[136] Moreover, the current wealth transfer tax system, for simplicity reasons and otherwise, does not replicate consistently the estate and gift tax consequences of successive intergenerational outright transfers.[137]

Accessions Tax. Since an accessions tax operates on the basis of actual receipts of gratuitous transfers of cash or property, regardless of origin, it is possible that Congress would find the considerations supporting a GST tax in the context of the estate and gift taxes less persuasive than in the context of an accessions tax. If Congress wants a generation-skipping feature, the simplest version would take the form of an increase in rates the younger the generation of the recipient in relation to the transferor.[138]

Income-Inclusion System. A GST tax is not logically consistent with an income tax, which generally treats the source of income as irrelevant. If Congress considers the income-inclusion system a substitute for a wealth transfer tax system and wants a generation-skipping feature, it could impose a periodic wealth tax on trusts. As an alternative, Congress could design a free-standing GST tax.

Deemed-Realization System. Although a GST tax is not logically consistent with an income tax, Congress may have concerns that transferors could use long-term trusts to defer future realization of gains. Congress could address this concern by treating in-kind trust distributions as realization events. Alternatively, Congress could treat a trust's assets as having been sold and repurchased at periodic intervals, such as twenty-five years.[139]

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[133] IRC §§ 2601 (imposing tax), 2611 (defining taxable transfers), 2612 (defining taxable transfers), 2641 (providing the applicable rate of tax).

[134] The EGTRRA provides for its graduated increase up to $3.5 million in 2009. IRC § 2631(a). For further discussion of the GST exemption, see §§ 4.B and 27.C of the Report.

[135] IRC § 2612(c) (defining direct skips).

[136] For further discussion of direct skips, see § 27.D of the Report.

[137] For further discussion of the coordination of the GST tax with the estate and gift taxes, see § 27.B of the Report.

[138] Such a system, however, would require identification of the transferor, which is otherwise an irrelevant fact under an accessions tax.

[139] *See supra* § 4.

§ 17. Property Previously Taxed

Current System. The current wealth transfer tax system provides a credit for property subject to an estate tax more than once within a relatively short period of time.[140] The credit does not extend to the gift tax or the GST tax, even though either might have been assessed within a relatively short period of time of the estate tax.[141]

Accessions Tax. Under an accessions tax, the question of previously taxed property relates to the death of a person (Transferee 1) shortly after receiving a taxable accession, resulting in an accession by a transferee of Transferee 1 (Transferee 2). One response to this concern is that the problem is not the frequency of taxation, but that an accessions tax applies to the same property acquired by persons in the same generation or an older generation.[142] Congress could address that problem by providing that a transfer that Transferee 2 receives is exempt from taxation, if Transferee 2 is in the same generation as, or an older generation than, Transferee 1. Under this approach, Congress would ignore the frequency of the tax on transfers. If Congress is concerned about the frequency of taxation, it could adopt a special disclaimer rule to address that problem.

Income-Inclusion System. Since the income tax is not a wealth transfer tax, the frequency of taxation of an asset has no relevance. Nevertheless, Congress could adopt one or both of the approaches for an accessions tax that are described above.

Deemed-Realization System. Under the deemed-realization system, property previously taxed within a short period of time is not a concern. The transferee (Transferee 1) takes a basis equal to the transferred asset's fair market value at the time of the transfer. Therefore, if Transferee 1 subsequently transfers that asset within a short period of time, whether by reason of death or lifetime gift, to Transferee 2, the only amount subject to tax is the gain that has accrued during the time that Transferee 1 held the property.

§ 18. International Transfers

In the following discussion, the term "U.S. person" refers to a person who is a citizen or resident of the United States, and the term "nonresident alien" refers to an individual who is not a U.S. citizen or resident. The status of a trust as either domestic or nondomestic generally depends on the location of the trust.

Current System. The current wealth transfer tax system taxes a transferor who is a U.S. person without regard to the status of the recipient, including trusts and trust beneficiaries, except for noncitizen spouses. The estate tax law denies a marital deduction for a transfer to a noncitizen spouse, unless the transfer is to a qualified domestic trust, or other steps are taken to assure that the property will be subject to the estate tax at the death of the surviving noncitizen

[140] IRC § 2013.

[141] For further discussion of previously taxed property, see §§ 22 and 27.B.2 of the Report.

[142] For further discussion of generational issues relating to previously taxed property, see § 22 of the Report.

spouse.[143] The gift tax law also denies a marital deduction for a lifetime transfer to a noncitizen spouse, but it allows an annual exclusion of up to $100,000 (indexed) for gifts to a noncitizen spouse.[144]

With respect to a transferor who is a nonresident alien, the estate and gift tax laws apply only to property located in the United States.[145] This includes all stock in domestic corporations but excludes certain bank accounts held in U.S. banks.[146] The nationality of the transferee is irrelevant. Treaties whose main purpose is to prevent double taxation may slightly modify these rules.

Accessions Tax. Under an accessions tax, the status of the recipient would be crucial. If a recipient who is a U.S. person receives a gratuitous transfer from a nonresident alien, the receipt of the property would be considered a taxable accession. Conversely, a receipt by a nonresident alien from a transferor who is a U.S. person would not be considered a taxable accession.

The treatment of a transfer of property made to a trust varies depending upon whether a distribution from a trust is to a U.S. person or to a nonresident alien. Under an accessions tax, a transfer of property to a trust is not considered an accession, regardless of whether the trust is domestic or nondomestic. A distribution by a trustee to a beneficiary who is a U.S. person would be treated as an accession and subject to tax. A distribution to a beneficiary who is a nonresident alien would not be treated as an accession and would be exempt from tax. The location of the trust or the status of the transferor is irrelevant.

The adoption of an accessions tax would require an analysis of each transfer tax treaty.

Income-Inclusion System. Under an income-inclusion system, a transfer from a nonresident alien to a U.S. person would be treated as income and subject to tax. A transfer by a U.S. person to a nonresident alien would not be treated as income. The tax consequences for a nonresident alien could change if Congress were to amend the income tax law to treat a receipt of property from a U.S. person as U.S.-source income.[147]

If a trust, either domestic or nondomestic, qualifies as a grantor trust under the income tax law, the receipt of property by the trust would not be treated as income.[148] A distribution from a grantor trust would be treated as a transfer made by the transferor to a distributee.

If the income-inclusion system generally were to treat nongrantor trusts as taxpayers and treat contributions from transferors as income, then the distinction between domestic and nondomestic trusts would have relevance. A transfer by a nonresident alien or a U.S. person to a domestic trust would be treated as income and subject to tax. A nonresident alien should receive a tax refund upon receipt of a distribution of previously taxed income. Presumably, at a minimum, a transfer by a U.S. person to a nondomestic trust would be treated as a realization event, as the income tax law now provides.[149] Congress could treat a nondomestic trust as a

[143] IRC §§ 2056(d), 2056A.
[144] IRC § 2523(i).
[145] IRC §§ 2101, 2103–2106 (estate tax), 2501(a)(1), 2511(a) (gift tax).
[146] IRC § 2104; Treas. Reg. § 25.2511-3(b)
[147] Congress could amend IRC § 861 to accomplish this result.
[148] *See* IRC §§ 671–678.
[149] *See* IRC § 684.

grantor trust in any year in which the trust has a beneficiary who is a U.S. person.[150] Alternatively, Congress could treat a nondomestic trust as a domestic trust in some limited situations and tax transfers to that nondomestic trust. In those situations in which Congress does not treat a nondomestic trust either as a grantor trust or a domestic trust, a distribution to a U.S. person would be treated as income.

Deemed-Realization System. A deemed-realization system would treat a gratuitous transfer by a U.S. person as a realization event, regardless of whether the recipient is a U.S. person or a nonresident alien. A transfer by a nonresident alien to a U.S. person would be treated as a realization event and subject to applicable income tax rules.[151]

A transfer by a U.S. person to either a domestic or a nondomestic trust, other than a grantor trust, would be treated as a realization event. When a transfer of property to a trust is treated as a realization event, one issue that arises is whether the distribution of that property also should be treated as a realization event. In the case of a grantor trust, the deemed-realization event would be the distribution of property to a person other than the transferor, any other event during the grantor's life that would cause the trust to cease to be a grantor trust, or the death of the transferor.

§ 19. Transition

If the current wealth transfer tax system were to be replaced with one of the three alternative tax systems, a challenge for Congress would be to design transition rules that prevent inappropriate double taxation.

Accessions Tax. If Congress were to adopt an accessions tax, an underlying premise in developing transition rules probably would be to exclude from the accessions tax any amount previously taxed under the wealth transfer tax system. Thus, if a transferor had incurred either estate or gift tax upon the creation of a trust, an accessions tax would not treat distributions of income or principal from that trust as accessions (at least up to the amount of property previously taxed). On the other hand, if a transferor had made a transfer of property to a trust that was incomplete for gift tax purposes and also was not subject to the estate tax, because the transferor died after Congress repealed the estate tax, an accessions tax could appropriately apply to that trust and to distributions from that trust.

Income-Inclusion System. As under current law, income that arises after a transfer that is subject to estate or gift tax, nevertheless, can be taxed to the transferor, the trust, or the beneficiaries, as the case may be.

Deemed-Realization System. If Congress were to adopt a deemed-realization system, it simply could apply the deemed-realization rule to transfers that a transferor makes after the date of enactment, unless the entire fair market value of the property previously has been subject to

[150] *See* IRC § 683.
[151] *See, e.g.*, IRC §§ 871, 897.

estate or gift tax with respect to that transferor. This is the simplest method, but it may frustrate the expectations of taxpayers who have adopted estate plans and have taken other actions predicated on existing law.[152] Concern about taxpayers' expectations, however, may be balanced by the benefits that taxpayers would gain by repeal of the current wealth transfer tax system.

Alternatively, Congress could apply the deemed-realization system only to assets acquired by a transferor after the date of enactment. Under this approach, Congress would have to formulate rules to determine what constitutes the acquisition date of an asset. Also, Congress would have to retain the carryover basis rule of IRC § 1015 for a gift of an asset acquired before the date of enactment. In addition, for an asset acquired by a decedent before the date of enactment, Congress would have to retain IRC § 1014 to allow a transferee to take a basis equal to that asset's fair market value determined at the time of that decedent's death, even if that decedent's estate would not have paid any estate tax. Further, for an asset acquired before the date of enactment, Congress would have to exempt from income taxation changes in that asset's value that occur after the date of enactment.

Yet a third option is for Congress to apply the deemed-realization system to all property at the time of enactment, but to provide each asset with a basis equal to its fair market value at the time of enactment. Notwithstanding its high compliance and administrative costs, the benefit of this option is that postenactment gain for property acquired before enactment of the deemed-realization system would not escape taxation.

Congress could continue to apply current grantor trust rules to those trusts established before the date of enactment. Alternatively, for those trusts, Congress could amend current grantor trust rules to conform to a newly enacted deemed-realization system.

[152] Congress could draw distinctions between substantive reliance or expectations (i.e., the belief that tax would never be paid on such gains) and procedural reliance (i.e., the belief that no records on the basis of property needed to be kept). Congress also could grant transition relief that specifically addresses the absence of records. Congress further could adopt a contrary view and challenge the assumption that either substantive or procedural expectations were justified in the first place.

EXHIBIT A
BACKGROUND PAPER ON THE CANADIAN TAXATION OF GAINS AT DEATH

by Professor Lawrence A. Zelenak, Columbia Law School

In 1972, Canada simultaneously repealed its estate tax and introduced income taxation of capital gains. For purposes of the new capital gains tax, both death and the making of an *inter vivos* gift were treated as realization events. From a U.S. perspective, treating gratuitous transfers as realization events is the most interesting aspect of the Canadian system. From the Canadian perspective, however, the major 1972 income tax innovation was taxing capital gains at all. This paper briefly describes: (i) the general structure of the Canadian system for taxing capital gains, (ii) the specific rules applicable to gifts and bequests of appreciated (and depreciated assets), and (iii) special basis rules applicable to assets acquired by taxpayers before the effective date of the 1972 legislation. The paper concludes with a few comments on the relevance of the Canadian experience to the current U.S. interest in repealing the tax-free basis step-up at death (IRC § 1014) in connection with estate tax repeal.

1. Canadian Taxation of Capital Gains: The General Structure

A Canadian taxpayer must include one-half of capital gains in taxable income, with the taxable portion taxed at the same rates as ordinary income. For the most part, realization and recognition rules are the same as under the U.S. income tax, with the important exception that both transfers at death and *inter vivos* gifts are taxable events. The amount realized on a gratuitous transfer equals the fair market value of the asset at the time of the transfer. Donation of a capital asset to charity is also a taxable event, but generally only one-quarter of the realized gain is included in taxable income. (The entire gain is excluded in the case of certain contributions of “certified cultural property.”) The deemed amount realized on the charitable contribution is also the amount of the contribution for purposes of calculating the charitable donation credit.

A gain on the disposition of the taxpayer’s principal residence ordinarily is exempt from tax. The law also allows a taxpayer to exclude, on a cumulative lifetime basis, $500,000 of gain realized on the disposition of “qualified farm property” or “qualified small business corporation shares.” This is accomplished through a $250,000 “capital gains deduction,” which offsets the one-half of $500,000 of qualified gain, which otherwise would be subject to tax.

Just as a taxable capital gain is only half of the actual gain, so an allowable capital loss is only half of the actual loss. An allowable capital loss may be claimed against taxable capital gain to the extent thereof. A net capital loss (i.e., an allowable capital loss in excess of a taxable capital gain) may be carried back three years and forward indefinitely.

For purposes of calculating gain on the disposition of personal use property, basis is the greater of the taxpayer’s actual cost or $1,000. Losses on personal use property are not deductible, except in the case of “listed personal property” (generally, art and other collectibles). Losses on listed personal property may be used to offset gains on other listed personal property (but not gains on other types of capital assets), and may be carried back three years and forward seven years.

2. Rules Specific to Gratuitous Transfers

Despite the general treatment of gratuitous transfers as realization events, tax is not imposed on gifts and bequests between spouses (including transfers to spousal trusts). The recipient spouse takes the property with the transferor spouse's basis. If the recipient spouse sells the property while the transferor spouse is still alive and the spouses are still married, any gain is taxed to the transferor spouse. In the case of a spousal transfer at death, nonrecognition applies only if the property becomes "indefeasibly vested" in the recipient spouse (or trust) within 36 months of the date of the transferor spouse's death. Nonrecognition for a spousal transfer at death may be waived (to recognize a loss, to take advantage of the decedent's $250,000 capital gains deduction, or to take advantage of an otherwise unusable net capital loss of the decedent). If nonrecognition is waived, the recipient spouse's basis is the property's date-of-death fair market value. Elective nonrecognition also is available for farm property indefeasibly vested in a child of the decedent within 36 months of the date of the decedent's death.

Special favorable rules apply to a net capital loss for the year of death. There are two options. (i) The loss may be carried back three years against capital gains, and any loss remaining after carryback may be used against ordinary income in the year of death, the preceding year, or both. (ii) The decedent's representative may forgo the use of the loss against prior years' capital gains, and instead deduct the loss against ordinary income in the year of the decedent's death, the preceding year, or both.

If the decedent had an unused net capital loss from before the year of death, that loss is applied first against capital gains on the final return, and then against other income on the final return, the return for the preceding year, or both.

An installment payment option is available for tax due on the deemed disposition of capital assets at death. Interest is charged, and security is required.

To prevent the use of trusts to avoid the death gains tax, a trust is taxed on a deemed disposition of its capital assets every 21 years.

In the United States, some have claimed that repeal of IRC § 1014 (in favor of either realization at death or carryover basis) would give rise to tremendous difficulties in determining decedents' bases in assets owned at death. Revenue Canada officials told the author (in 1992) that basis determination had not been a major problem in the administration of the death gains tax (with respect to assets acquired after 1971, for which basis equals the taxpayer's actual cost).

3. Basis Transition Rules

Special rules apply in determining the basis of property acquired by a taxpayer before 1972 (the first year of capital gains taxation). These rules apply whether the taxable disposition is by sale or by gratuitous transfer. A taxpayer may elect either of two basis regimes for such property, but whichever regime is chosen will apply to all such assets disposed of by the taxpayer. (i) The taxpayer may simply elect to have basis equal to fair market value as of the "valuation day" (December 21, 1971, for publicly traded stock and securities, and December 31, 1971, for all other capital assets). (ii) The taxpayer may elect to have basis equal the median of: (a) the taxpayer's actual cost, (b) the fair market value as of the valuation day, or (c) the amount realized on the disposition. The effect of this option is similar to that of the bifurcated basis for gifted depreciated assets prescribed by IRC § 1015. If a taxpayer who has chosen this method sells an asset that had a built-in loss as of the valuation day, there will be no gain unless the amount realized exceeds the taxpayer's actual cost, and there will be no loss unless the amount realized is less than the fair market value as of the valuation day.

Revenue Canada officials told the author (in 1992) that valuation day valuations were almost always made retrospectively, at the time of the taxable disposition (except, of course, in the case of publicly traded stock and securities). This process has worked reasonably well for real estate, because Revenue Canada assembled a massive database of real estate sales near the valuation day. Retrospective valuations of closely held businesses have been more difficult.

4. The Relevance of the Canadian Experience to the Current U.S. Situation

a. A Different Status Quo Ante. In Canada, the death gains tax was introduced as part of the introduction of a general capital gains tax. In the United States, by contrast, repeal of IRC § 1014 would take place in the context of an existing system of capitals gains taxation. In the Canadian situation, the valuation day fresh start may have been justified on both substantive and procedural grounds. Substantively, taxpayers making investment decisions may have reasonably and detrimentally relied on their understanding that pre-1972 appreciation would never be subject to the income tax. Procedurally, the absence of any pre-1972 capital gains tax made it reasonable for owners of assets acquired before 1972 not to have kept basis records. In the United States, by contrast, owners of capital assets always have held their assets with the knowledge that a capital gains tax would apply, and that basis records thus would be needed, unless they were able to hold the assets until death. This always-present potential for taxation seriously weakens both the substantive and procedural arguments for a valuation day fresh start approach if IRC § 1014 is replaced permanently by either taxation at death or a carryover basis rule.

On the other hand, some U.S. taxpayers may have failed to keep basis records for some assets in the reasonable belief that they would not dispose of those assets before death. For this reason, determining bases of U.S. decedents (for purposes of either taxation at death or carryover basis) may not be as straightforward as the Canadian experience with assets acquired after 1971. Canadian taxpayers knew that basis records would be required for all assets acquired after 1971, whether they disposed of those assets during their lifetimes or at death.

b. How Much Special Solicitude for Transfers at Death Is Appropriate? By comparison with Canadian law, the tax-free basis step-up rules of new IRC § 1022 ($1.3 million generally, and an additional $3 million for "qualified spousal property") are extremely generous. The Canadian valuation day rule is not comparable, both because it applies regardless of the nature of the taxpayer's disposition of the property, and because it is only a transition rule (applicable only to assets acquired before a specific date). The $500,000 lifetime exemption for farms and small business stock also is not comparable. It applies regardless of the nature of the disposition, it is limited to narrow classes of assets, and it is relatively modest in amount. In short, the Canadian system provides no permanent gain forgiveness targeted specifically at transfers at death. The special solicitude for deathtime transfers in the Canadian law is quite limited, consisting only of: (i) deferral of gain recognition for spousal transfers, (ii) deferral of gain recognition for transfers of farms to the decedent's children, (iii) special rules with respect to the deductibility of capital losses, and (iv) the option of paying the death gains tax in installments.

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* The CCRA publications are available at www.ccra.gc.ca.

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

	Gift Tax	*Estate Tax*	*GST Tax*
2001	$ 675,000	$ 675,000	$1,060,000
2002	$1,000,000	$1,000,000	$1,100,000
2003	$1,000,000	$1,000,000	$1,120,000
2004	$1,000,000	$1,500,000	$1,500,000
2005	$1,000,000	$1,500,000	$1,500,000
2006	$1,000,000	$2,000,000	$2,000,000
2007	$1,000,000	$2,000,000	$2,000,000
2008	$1,000,000	$2,000,000	$2,000,000
2009	$1,000,000	$3,500,000	$3,500,000
2010	$1,000,000	Repealed	Repealed
2011	$1,000,000	$1,000,000	$1,120,000 (indexed)