

## ESTATE AND GIFT

### RESTORE PHASE-OUT OF UNIFIED CREDIT FOR LARGE ESTATES

#### Current Law

[890] Prior to the Taxpayer Relief Act of 1997, the five-percent surtax added to the estate tax gradually phased out two benefits for estates with a value above \$10 million: the benefit of the estate tax brackets below 55 percent and the benefit of the unified credit. The Taxpayer Relief Act of 1997 amended the unified credit, increasing it gradually over the years 1998 through 2006 and effectively increasing the amount exempt from the estate and gift tax from \$600,000 (in 1997) to \$1,000,000 (in 2006). In attempting to amend the surtax provision to accommodate the scheduled increases to the unified credit, the Taxpayer Relief Act of 1997 inadvertently altered the operation of the surtax such that it currently phases out only the graduated estate tax brackets and does not phase out the benefit of the unified credit.

#### Reasons for Change

[891] As evidenced by the legislative history of the Taxpayer Relief Act of 1997, there was no intention to change the application of the five percent surtax. The inadvertent reduction in the surtax gave an estate tax reduction to estates in excess of \$17,184,000.

#### Proposal

[892] The proposal would increase the range of the five-percent surtax in order to restore its purpose of phasing out the benefit of the unified credit as well as the benefit of the graduated estate tax brackets. The phase-out range would increase as the unified credit continues to rise until 2006.

[893] This proposal would be effective for decedents dying after the date of enactment.

## REQUIRE CONSISTENT VALUATION FOR ESTATE AND INCOME TAX PURPOSES

### Current Law

[894] Under current law, the basis of property acquired from a decedent is the fair market value of the property on the date of death. In addition, property included in the gross estate of a decedent generally is valued at its fair market value on the date of death. However, there is no requirement that the determination of fair market value for estate tax purposes and the determination of fair market value for income tax purposes be consistent. The only current duty of consistency for estates concerns the duty of the beneficiary of a trust or estate to report for income tax purposes consistent with the Form K-1 information received from the trust or estate (section 6034A). The K-1, however, does not include basis information.

[895] When a lifetime gift of property is made, the donee generally takes a carryover basis in the property. (Adjustments are made if gift tax is paid on the transfer, and the dual basis rules apply if the property is later sold at a loss.) However, there is no duty on the donor to notify the donee of the basis.

### Reasons for Change

[896] Taxpayers should be required to take consistent positions when dealing with the Internal Revenue Service. The rationale for the step-up in basis at death

is linked to the inclusion of the property in the estate of the decedent. Therefore, the reported estate tax value and the new basis should be the same. In the case of a gift in which the donee takes a carryover basis, the donor is in the best position to notify the donee of the basis. If such information is not passed on to the donee at the time of the gift, such information may be lost or unavailable by the time the property is sold by the donee.

## Proposal

[897] The proposal would impose both a duty of consistency and a reporting requirement. First, a person taking a basis under section 1014 (property acquired from a decedent) would be required to use fair market value as reported on the estate tax return (if one is filed) as the basis for the property for income tax purposes. Second, a reporting requirement would be imposed on the estate (the executor) and the donor of a lifetime gift. The estate, by its executor, would be required to notify each heir of the fair market value on the date of death as reported on the estate tax return for any property distributed to such heir. This requirement would include property not passing under the will if such property is included in the gross estate. Donors of gifts (other than annual exclusion gifts) would be required to notify donees of the donors basis in the property at the time of the transfer, as well as any payment of gift tax that would increase basis. Copies of these notices must be furnished to the IRS.

[898] The proposal would be effective for transfers after the date of enactment in the case of lifetime gifts, and decedents dying after the date of enactment in the case of transfers at death.

## REQUIRE BASIS ALLOCATION FOR PART SALE/PART GIFT TRANSACTIONS

### Current Law

[899] Under current law, where there is a transaction that is part gift, part sale, the treatment of the donor and the donee are as follows: The donee takes a basis equal to the greater of the amount paid by the donee or the donors adjusted basis at the time of the transfer. (As in any gift transaction, however, there is a "dual basis," that is, if the property is later sold at a loss, the basis is limited to the fair market value at the time of the gift.) No special treatment of the donor is specified under current law. Thus donors presumably take the position that their basis is adjusted cost basis. This treatment by the donor and donee is not necessarily consistent.

#### Reasons for Change

[900] The donor and the donee in a part gift, part sale transaction should be required to take consistent positions so that no basis is lost or created by the transaction. Simple and rational rules are needed to allocate basis between the gift portion and the sale portion of the transaction.

#### Proposal

[901] This proposal would rationalize basis allocation in a part gift, part sale transaction by adopting the rule applied to bargain sales to charity under Code section 1011: the basis of part gift, part sale property would be allocated ratably between the gift portion and the sale portion based on the fair market value on the date of transfer and the consideration paid. For example, if the donor transferred property with a basis of \$40,000 and a fair market value of \$100,000 to child, and child paid consideration of \$50,000, child would take a basis of \$70,000 (\$50,000 for the consideration plus \$20,000 allocated portion of the donors basis) and the donor would take a basis of \$20,000 (allocated portion of donors basis on the date of transfer) for the purpose of reporting the gain on the sale part of the transaction. The donor would realize gain in the amount of \$30,000 (\$50,000 less \$20,000). The dual basis rule would continue to apply if there is a loss transaction and the fair market value on the date of the gift was

less than basis. For example, take the facts from above except the donor's basis just prior to the transfer was \$140,000. The donor would have a loss of \$20,000 (\$50,000 of consideration less allocated basis of \$70,000). Child's unadjusted basis would be \$120,000, but if child sold the property at a loss, basis would be limited to \$100,000. As under present law, if the amount realized from the sale by child is between the basis for loss and the basis for gain, no gain or loss is realized.

[902] This proposal would be effective for transactions entered into after the date of enactment.

## CONFORM TREATMENT OF SURVIVING SPOUSES IN COMMUNITY PROPERTY STATES

### Current Law

[903] Subject to limited exceptions, property acquired from a decedent at death is assigned a new basis equal to the fair market value of the property at the date of the decedent's death (a "stepped-up basis"). In a common law (non-community property) State, property jointly owned by husband and wife at the time one of them dies is treated as owned one-half by the deceased spouse and one-half by the surviving spouse. The surviving spouse receives a stepped-up basis in the deceased spouse's half. The half already owned by the surviving spouse, however, is not eligible for a step up in basis. Similarly, in a community property State, each spouse is treated as owning one-half of the community property. Under section 1014(b)(6), however, the surviving spouse is entitled to a stepped-up basis in the portion of the community property owned by the surviving spouse, as well as the portion owned by the decedent.

[904] At present, there are 9 community property States and at least one other State with an elective community property regime.

## Reasons for Change

[905] When enacted in 1948, the stepped-up basis for community property was premised on the fact that "the usual case was that practically all the wealth of the married couple was the property of the husband." S. Rep. 1013, 80th Cong., 2d Sess. (1948), 1948-1 C.B. 285, 304. Societal changes and changes to the estate tax treatment of jointly held property in 1981 have undermined the premises on which section 1014(b)(6) was based. Consequently, surviving spouses in community property States now enjoy an unwarranted tax advantage over those in common law States.

## Proposal

[906] The proposal would eliminate the stepped-up basis in the part of the community property owned by the surviving spouse prior to the deceased spouse's death. The half of the community property owned by the deceased spouse would continue to be entitled to a stepped-up basis.

[907] This proposal would be effective for decedents dying after the date of enactment.

## INCLUDE QUALIFIED TERMINABLE INTEREST PROPERTY (QTIP) TRUST ASSETS IN SURVIVING SPOUSE'S ESTATE

## Current Law

[908] A marital deduction is allowed for qualified terminable interest property (QTIP) passing to a qualifying trust for a spouse either by gift or by bequest. Under section 2044, the value of the recipient spouse's estate includes the value of any such property in which the decedent had a qualifying income interest for life and a deduction was allowed under the gift or estate tax. Under section 2519, any disposition of all or part of a spouse's qualifying income interest for life for which a gift or estate tax marital deduction was allowed is treated as a transfer of

all other interests in the property. Property treated as transferred under section 2519 is not included in the spouse's estate under section 2044.

#### Reasons for Change

[909] The marital deduction is intended to defer the estate tax until the death of the surviving spouse, not to excuse payment of the tax permanently. In some cases, taxpayers have attempted to whipsaw the government by claiming the marital deduction for QTIP property in the first estate and then, after the statute of limitations for assessing tax on the first estate has elapsed, arguing against inclusion under section 2044 in the second estate due to some technical flaw in the QTIP eligibility or election in the first estate. Since the surviving spouse has benefitted from the deferral of estate tax due to the marital deduction taken in the first estate, the property should be includible in the surviving spouse's estate even if the surviving spouse later discovers that the marital trust did not in fact qualify for the QTIP election in the first estate. If there is a transfer of the spouse's interest during the spouse's life, the same potential for whipsaw exists. Therefore, the existence of a qualifying income interest for life should not be determinative under section 2519. Rather, if a marital deduction is allowed for QTIP property, the property should be treated as QTIP for 2519 purposes as well.

#### Proposal

[910] The proposal would amend section 2044 to provide that, if a marital deduction is allowed with respect to property under section 2523(f) or 2056(b)(7), inclusion is required in the beneficiary spouse's estate under section 2044. The proposal would also amend section 2519 so that if there is a disposition of a spouse's interest in property for which a deduction under 2523(f) or 2056(b)(7) was allowed, there is a deemed disposition of all other interests in the property.

[911] The proposal would be effective for decedents (i.e., surviving spouses) dying and dispositions of property after the date of enactment.

## ELIMINATE NON-BUSINESS VALUATION DISCOUNTS

### Current Law

[912] Under current law, taxpayers making gratuitous transfers of fractional interests in entities routinely claim discounts on the valuation of such interests. The concept of valuation discounts originated in the context of active businesses, where it has long been accepted that a willing buyer would not pay a willing seller a proportionate share of the value of the entire business when purchasing a minority interest in a non-publicly traded business.

[913] Without legislation in this area, tax planners have carried this concept over into the family estate planning area, where a now common planning technique is to contribute marketable assets to a family limited partnership or limited liability company and make gifts of minority interests in the entity to other family members. Taxpayers then claim large discounts on the valuation of these gifts.

### Reasons for Change

[914] The use of family limited partnerships and similar devices is eroding the transfer tax base. Taxpayers take the position that they can make value disappear by making contributions of marketable assets to an entity, and then making gifts of interests in such entity to family members. This disappearing value is illusory, because family members are not minority interest holders in any meaningful sense. Moreover, it is implausible that the donor would intentionally take an action (contribution of the property to an entity) if the donor really believed that such action would cause the family's wealth to decline substantially.

### Proposal

[915] The proposal would eliminate valuation discounts except as they apply to active businesses. Interests in entities would be required to be valued for transfer tax purposes at a proportional share of the net asset value of the entity to the extent that the entity holds non-business assets (such as cash, cash equivalents, foreign currency, publicly traded securities, real property, annuities, royalty-producing assets, non-income producing property such as art or collectibles, commodities, options and swaps) at the time of the gift or death. To the extent the entity conducts an active business, the reasonable working capital needs of the business would be treated as part of the active business (i.e., not subject to the limits on valuation discounts). No inference is intended as to whether these discounts are allowable under current law.

[916] This proposal would be effective for transfers made after the date of enactment.

## ELIMINATE GIFT TAX EXEMPTION FOR PERSONAL RESIDENCE TRUSTS

### Current Law

[917] Under section 2702, if an interest is retained by a grantor in a trust when other interests are transferred to family members, the retained interest is valued at zero for gift tax purposes unless it takes the form of an annuity (a GRAT), a unitrust (a GRUT), or a remainder interest after a GRAT or a GRUT. However, section 2702(a)(3)(A)(ii) provides an exception for a trust "all the property in which consists of a residence to be used as a personal residence by persons holding term interests in such trust." As written, this exemption completely removes personal residence trusts from the purview of section 2702.

### Reasons for Change

[918] Because the exemption under section 2702 completely removes personal residence trusts from section 2702, such trusts receive more favorable gift tax

treatment than that given to the statutorily authorized GRATs and GRUTs. Specifically, when valuing the gift made to the remainderman in a personal residence trust, the value of any reversionary interest in the grantor can be taken into account, and such value reduces the amount of the taxable gift. In contrast, even if the grantor has a reversionary interest in a GRAT or a GRUT, section 2702 prohibits the actuarial value of that interest from being taken into account in valuing the gift.

[919] Furthermore, by requiring a grantors retained interest in a trust to take the form of an annuity or a unitrust, section 2702 was attempting to make sure that the grantor would actually receive the interest valued by the actuarial tables. This requirement was designed to prohibit the pre-2702 grantor retained income trust (GRIT), in which the actuarial tables were used to value the grantors retained income interest even when the projected income was zero or minimal.

[920] Experience has shown that the use value of the residence retained by the grantor is a poor substitute for an annuity or unitrust interest. In the personal residence trust, the grantor ordinarily remains responsible for the insurance, maintenance and property taxes on the residence. Therefore, the true rental value of the house should be less than fair market rent. In these circumstances, the actuarial tables overstate the value of the grantors retained interest in the house.

### Proposal

[921] The proposal would repeal the personal residence exception of section 2702(a)(3)(A)(ii). If a residence is used to fund a GRAT or a GRUT, the trust would be required to pay out the required annuity or unitrust amount; otherwise the grantors retained interest would be valued at zero for gift tax purposes.

[922] The proposal would be effective for transfers in trust after the date of enactment.

## MODIFY REQUIREMENTS FOR ANNUAL EXCLUSION GIFTS

### Current Law

[923] Under section 2503(b), gifts of "present interests" of a value of up to \$10,000 (indexed for inflation) per donor per donee each year are excepted from the gift tax (the "annual exclusion"). Generally, a transfer in trust is not considered a transfer of a present interest to the beneficiary of the trust. Under the decision in *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), however, a transfer in trust is considered a transfer of a present interest if the trust instrument permits the beneficiary to withdraw the transferred amount for a limited period of time (often 30 days or less). Thus so-called "Crummey powers" are often used to enable a transfer of a \$10,000 gift to a trust to qualify for the annual exclusion under section 2503(b).

[924] In the *Crummey* case, the holder of the withdrawal power was the ultimate beneficiary of the trust. In more recent cases, such as *Estate of Cristofani v. Commissioner*, 97 TC 74 (1991), and *Estate of Kohlsaat v. Commissioner*, 73 TCM 2732 (1997), the trust agreement has been drafted to give withdrawal rights to individuals who do not have substantial economic interests in the trust. Typically, by pre-arrangement or understanding, none of these withdrawal rights will be exercised.

[925] An annual exclusion is also available under the generation-skipping transfer tax (GST). The GST annual exclusion provides that it does not apply to any transfer to a trust for the benefit of an individual unless (i) 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 (ii) if the trust does not terminate before the individual dies, the assets of such trust will be includible in the gross estate of such individual. See Section 2642(c).

### Reasons for Change

[926] The granting of a withdrawal right to a person who does not have a primary interest in the trust in order to obtain the use of an additional annual exclusion constitutes an unreasonable expansion of the annual exclusion provision and the Crummey decision. Thus, the Cristofani and Kohlsaas decisions should be overruled. In addition, the mechanics of issuing withdrawal notices under Crummey are burdensome. Finally, the differing requirements for an annual exclusion under the gift tax and the GST provide a trap for the unwary. The area would be simplified if the gift tax rules and the GST rules were conformed.

#### Proposal

[927] The proposal would conform the gift tax annual exclusion rule to the generation-skipping transfer tax rule. That is, the gift tax annual exclusion would not apply to any transfer to a trust for the benefit of an individual unless (i) 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 (ii) if the trust does not terminate before the individual dies, the assets of such trust will be includible in the gross estate of such individual. No withdrawal right or notice to the beneficiary would be necessary for a transfer to such a trust to qualify for the annual exclusion. The proposal would be effective for transfers to trusts after December 31, 2000. A grandfather rule would apply to trusts in existence on the date of enactment. The grandfather rule would maintain existing law (allowing the use of Crummey powers to create a present interest) but would disallow any annual exclusion attributable to a withdrawal right in a person who is not a primary, noncontingent beneficiary of the trust.

[928] The Secretary may prescribe regulations necessary to carry out the purposes of this proposal, including rules for determining whether an annual exclusion is attributable to a withdrawal right.