

[JOINT COMMITTEE PRINT]

**DESCRIPTION OF TAX BILLS**

**(S. 1695, S. 1733, and S. 1734)**

**RELATING TO**

**GENERATION-SKIPPING TRANSFER TAX  
AND CERTAIN OTHER TAX MATTERS IN-  
VOLVING CODE SECTIONS 303, 2032A, AND 6166**

**SCHEDULED FOR A HEARING**

**BEFORE THE**

**SUBCOMMITTEE ON ESTATE AND GIFT TAXATION**

**OF THE**

**COMMITTEE ON FINANCE**

**ON NOVEMBER 4, 1981**

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**PREPARED FOR THE USE OF THE**

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**BY THE STAFF OF THE**

**JOINT COMMITTEE ON TAXATION**



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### INTRODUCTION

The Senate Finance Committee's Subcommittee on Estate and Gift Taxation has scheduled a hearing on November 4, 1981, regarding the generation-skipping transfer tax, and certain provisions of the Code relating to installment payment of estate tax, redemptions of stock in closely held corporations to pay estate tax and administration and funeral expenses, and current use valuation for estate tax purposes.

There are three bills and four additional matters scheduled for the hearing. The first bill, S. 1695 (Senator Symms), provides for the repeal of the generation-skipping transfer tax. S. 1733 (Senator Symms) and S. 1734 (Senator Baker for Senator Symms) and the four other tax matters relate to provisions allowing installment payment of estate tax, redemption of stock of closely held corporations to pay estate tax and administration and funeral expenses, and current use valuation.

The first part of the pamphlet is a summary of the bills and matters covered by the hearing. This is followed by a more detailed description of the bills and other matters, including present law, issues, explanation of the provisions of the bills, effective dates, and estimated revenue effects.



## **I. SUMMARY**

### **1. S. 1695—Senator Symms**

#### **Repeal of Generation-Skipping Transfer Tax**

Under present law, a tax is imposed on generation-skipping transfers under a trust or similar arrangement upon the distribution of the trust assets to a generation-skipping heir (for example, a great-grandchild of the grantor of the trust) or upon termination of an intervening interest in the trust (for example, upon termination of a life income interest in the trust held by the grantor's grandchild). The tax generally is effective for generation-skipping transfers made after June 11, 1976.

A transition rule is included in present law for generation-skipping transfers occurring pursuant to revocable trusts or wills in existence on June 11, 1976, if the instrument is not amended after that date to create or increase the amount of a generation-skipping transfer, and if the grantor or testator dies before January 1, 1983. Generation-skipping trusts that were irrevocable on June 11, 1976, are not subject to the tax.

The bill would repeal the tax on generation-skipping transfers retroactively to generation-skipping transfers occurring after June 11, 1976.

### **2. S. 1733—Senator Symms**

#### **Declaratory Judgment Procedure for Installment Payment of Estate Tax and Current Use Valuation**

Present law provides that certain real property used in a farm or other closely held business may be valued at its current use value instead of its fair market value at its highest and best use (sec. 2032A). If the specially valued property is disposed of or otherwise ceases being used by the heir for the farming or other closely held business purpose based upon which it was valued in the decedent's estate, there is a recapture of the tax benefit from the current use valuation. The amount of the recapture tax depends upon the fair market value of the real property at the decedent's death. However, under present law, there is no provision for judicial review of an Internal Revenue Service determination of the fair market value of the property which qualifies for current use valuation unless the entire election is disallowed.

Present law also allows the installment payment of estate taxes attributable to interests in certain closely held businesses (sec. 6166). If 50 percent of the value of the business is withdrawn from the business or disposed of, there is an acceleration of any remaining install-

ments. However, under present law, the determination by the Internal Revenue Service that the estate is not eligible for the installment payment, the amount of estate tax eligible for installment payment, and whether there was an accelerating event, is not subject to judicial review because no deficiency is involved.

With respect to the current use valuation provision (sec. 2032A), the bill would provide a statutory procedure to enable an executor to obtain a final determination of the fair market value through an administrative audit and a Tax Court declaratory judgment.

With respect to installment payment of estate taxes (sec. 6166), the bill would provide a Tax Court declaratory judgment procedure to determine (1) whether an estate is eligible for installment payment, (2) the amount of the adjusted gross estate determined on the basis of facts and circumstances in existence on the date for filing the decedent's tax return (from which it will be possible to determine the amount of estate tax that may be paid in installments), or (3) whether there is an acceleration of the time for payment of the deferred estate taxes.

### **3. S. 1734—Senator Baker (for Senator Symms)**

#### **Acceleration of Installment Payments of Estate Tax**

Section 6166 permits an estate to pay the estate taxes attributable to qualifying interests in closely held businesses in installments for up to 14 years (annual interest payments for four years, followed by up to ten annual installments of principal and interest). However, upon the occurrence of certain events, including the sale or other disposition of the qualifying interest in the closely held business, payment of the remaining unpaid tax is accelerated.

An exception to this acceleration rule is provided for transfers of property from the decedent's estate to the heirs. There is no requirement that the property pass to members of the decedent's family. Section 422 of the Economic Recovery Act of 1981 provided a further exception to this acceleration rule where the interest in a closely held business is transferred by an heir (or subsequent transferee) at his death to a family member of the heir (or subsequent transferee).

The bill would remove the limitation requiring that each subsequent transferee be a family member of the transferor from whom the property was received.

#### **4. Other Tax Matters Relating to Installment Payment of Estate Tax (Code sec. 6166) and Redemptions of Stock in Closely Held Corporations (Code sec. 303)**

##### ***a. Issues relating to acceleration of the installment payment of estate taxes***

Section 6166 permits an estate to pay the estate taxes attributable to qualifying interests in closely held businesses in installments for up to 14 years (interest only for four years, followed by up to 10 annual installments of principal and interest). However, upon the occurrence of certain events, including the withdrawal of

funds from the business, payment of the remaining unpaid tax is accelerated.

However, section 6166 provides several exceptions to these acceleration rules. One such exception provides that redemptions of stock under section 303 (relating to certain redemptions for the payment of estate taxes and certain other expenses) do not count as withdrawals for purposes of the acceleration rules, provided that an amount equal to the redemption proceeds is used to pay Federal estate taxes within a specified period.

Section 303 provides that the redemption of certain stock in closely held businesses to pay estate taxes, funeral expenses, and administration expenses will be treated as a sale or exchange (eligible for capital gains treatment) instead of a dividend (which would be taxed as ordinary income). Thus, section 303 redemption may be made for purposes other than payment of Federal estate taxes. However, if an amount equal to the redemption proceeds is not applied toward payment of Federal estate tax (which could occur where the proceeds are used to pay State death taxes, administration expenses, or funeral expenses and no other amounts are used to pay Federal estate taxes), the redemption will be considered a withdrawal for purposes of the acceleration rules under section 6166.

The issue is whether the exception to the acceleration rules for section 303 redemptions should be modified to treat redemption proceeds as not being withdrawn if an amount equal to those proceeds is used for any purpose permitted under section 303.

***b. Issues relating to the definition of an interest in a closely held business***

Section 6166 permits installment payment of the estate taxes attributable to qualifying interests in closely held businesses. Qualifying interests include: (A) an interest of a proprietor in a trade or business carried on as a proprietorship; (B) an interest of a partner in a trade or business carried on as a partnership if (i) 20 percent or more of the partnership's total capital interest is included in determining the decedent's gross estate or (ii) the partnership had 15 or fewer partners; or (C) stock in a corporation carrying on a trade or business if (i) 20 percent or more of the value of such corporation's voting stock is included in determining the decedent's gross estate or (ii) such corporation has 15 or fewer shareholders.

The value of a decedent's interest in partnership profits which is included in his gross estate is not treated as an interest in a closely held business in determining either (1) whether the estate taxes attributable to interests in closely held businesses may be paid in installments or (2) the amount of tax which may be paid in installments. Similarly, the value of partnership or corporate indebtedness included in the decedent's gross estate is not considered an interest in a closely held business for purposes of section 6166.

In determining the number of shareholders or partners, each individual generally is counted once. However, section 6166 also provides several rules for aggregating certain interests. First, under a spousal attribution rule, interests held in joint tenancy or as community property by an individual and his spouse are treated as held by one share-

holder or partner. This rule does not attribute individually titled property held by a spouse to the other spouse.

However, under the second so-called "family attribution" rule, partnership interests or stock held by family members of the decedent (e.g., father, mother, spouse, brothers, sisters and descendants) are treated as held by the decedent in counting the number of shareholders or partners for purposes of determining whether the business is closely held. Thus, with respect to jointly held property or community property held by the decedent and his spouse, these two attribution rules overlap. However, the family attribution rule is broader in that all interests owned by the spouse are considered as owned by a single shareholder or partner—the decedent, regardless of the form of ownership. On the other hand, the spousal attribution rule is broader in that it applies to all spouses, not just the decedent and his spouse as under the family attribution rule.

The family attribution rule, which treats interests held by certain family members as owned by the decedent for purposes of determining the number of shareholders, does not apply to interests owned by spouses of a decedent's brothers or sisters. Thus, if a decedent's brothers or sisters predecease him, the interests owned by their surviving spouses will be treated as owned by a partner or shareholder other than the decedent. If the number of partners or shareholders then exceeds 15, the business will not be considered closely held unless 20 percent or more of the value of the partnership's capital interest or the corporation's voting stock is included in the decedent's gross estate.

In order for a corporation to be eligible for special tax treatment under subchapter S of the Internal Revenue Code (which generally provides that the corporation's income or loss is taxed proportionately to the shareholders rather than the corporation), the corporation must have a limited number of qualifying shareholders. For taxable years beginning after December 31, 1981, section 232 of the Economic Recovery Tax Act of 1981 (ERTA) increased this maximum number from 15 to 25.

The issues are:

- (1) Whether the value of an interest in partnership profits which is included in a decedent's gross estate should be considered as an interest in a closely held business;
- (2) Whether the value of partnership or corporate indebtedness included in a decedent's gross estate should be considered an interest in a closely held business;
- (3) Whether the value of nonvoting stock includible in the decedent's estate should be considered for purposes of determining whether a corporation is closely held under the 20-percent test;
- (4) Whether the attribution rules should be modified (a) by combining the spousal and family attribution rules and (b) by expanding the family attribution rules to include interests held by spouses of a decedent's brothers and sisters (solely for purposes of section 6166); and
- (5) Whether it is appropriate to expand the section 6166 definition of a closely held business to include corporations with 25 or fewer shareholders because such corporations may be eligible to make a subchapter S election.

***c. Issues relating to the treatment of interest as an administration expense***

Where an estate is permitted to pay the estate taxes attributable to interests in closely held businesses in installments, the interest attributable to such installments accrues on the deferred taxes and is payable annually.

Present law permits the interest attributable to such installments to be deducted for estate tax purposes as an administration expense under section 2053 as the interest is paid. Because the amount of interest is based upon the unpaid estate tax while the estate tax liability is reduced by the interest deduction, a complicated interrelated computation is required. Further, because no deduction is permitted until the interest is actually paid or accrued, this computation must be adjusted with each payment.

The issue is whether interest attributable to installment payments of estate taxes should continue to be allowed as an administration expense under section 2053 and, if so, whether the computation needed to establish the amount of the deduction can be simplified.

## II. DESCRIPTION OF THE BILLS AND OTHER TAX MATTERS

### A. BILL RELATING TO GENERATION-SKIPPING TRANSFER TAX

#### S. 1695—Senator Symms

#### Repeal of Generation-Skipping Transfer Tax

##### *Present Law*

Under present law, a tax is imposed on generation-skipping transfers under a trust or similar arrangement upon the distribution of the trust assets to a generation-skipping heir (for example, a great-grandchild of the grantor of the trust) or upon termination of an intervening interest in the trust (for example, termination of a life income interest in the trust held by the grantor's grandchild).

Basically, a generation-skipping trust is one which provides for a splitting of the benefits between two or more generations that are younger than the generation of the grantor of the trust. The generation-skipping transfer tax is not imposed in the case of outright transfers to younger generation heirs or to a trust if the benefits are not split between two or more younger generations. Thus, no generation-skipping transfer tax is imposed upon a "generation-jumping" or "layering" transfer directly to the grantor's grandchildren or other lower generation heirs. In addition, the tax is not imposed if the younger generation heir has (1) nothing more than a right of management over the trust assets or (2) a limited power to appoint the trust assets among the lineal descendants of the grantor. Present law also provides a grandchild exclusion for the first \$250,000 of generation-skipping transfers per deemed transferor that vest in the grandchildren of the grantor.

The tax is substantially equivalent to the tax which would have been imposed if the property had been actually transferred outright to each successive generation (in which case, the gift or estate tax would have applied). For example, assume that a trust is created for the benefit of the grantor's grandchild during the grandchild's life, with remainder to the great-grandchild. Upon the death of the grandchild, the tax is computed by adding the grandchild's portion of the trust assets to the grandchild's estate and computing the tax at the grandchild's marginal estate tax rate. In other words, for purposes of determining the amount of the tax, the grandchild would be treated under present law as the "deemed transferor" of the trust property.

The grandchild's marginal estate tax rate is used for purposes of determining the tax imposed on the generation-skipping transfer, but the grandchild's estate is not liable for the payment of the tax. Instead,



the tax is generally paid out of the proceeds of the trust property. In determining the amount of the generation-skipping transfer tax arising after the death of the deemed transferor, the trust is entitled to any unused portion of the grandchild's unified transfer tax credit, the credit for tax on prior transfers, the credit for State death taxes, and a deduction for certain administrative expenses.

A transition rule is included in present law for generation-skipping transfers occurring pursuant to revocable trusts or wills in existence on June 11, 1976, if the instrument is not amended after that date to create or increase the amount of a generation-skipping transfer, and if the grantor or testator dies before January 1, 1983. Generation-skipping trusts that were irrevocable on June 11, 1976, are not subject to the tax.

#### ***Issue***

The issue is whether the tax on generation-skipping transfers should be repealed.

#### ***Explanation of the Bill***

The bill would repeal the generation-skipping transfer tax.

#### ***Effective Date***

The bill would apply to generation-skipping transfers occurring after June 11, 1976.

#### ***Revenue Effect***

It is estimated that the bill would have a negligible effect on budget receipts in the near-term. The long-term effect of the bill would be to reduce receipts by approximately \$280 million.

B. BILLS AND OTHER TAX MATTERS RELATING TO INSTALLMENT  
PAYMENT OF ESTATE TAX AND CURRENT USE VALUATION

1. S. 1733—Senator Symms

Declaratory Judgment Procedure for Installment Payment of  
Estate Tax and Current Use Valuation

*Present Law*

*Current use valuation (sec. 2032A)*

For estate tax purposes, real property ordinarily must be included in a decedent's gross estate at its fair market value based upon its highest and best use. If certain requirements are met, however, present law allows family farms and real property used in a closely held business to be included in a decedent's estate at its current use value, rather than its full fair market value, provided that the gross estate may not be reduced by more than a specified amount (sec. 2032A).<sup>1</sup>

If, within 10 years of the decedent's death<sup>2</sup> (and before the death of the heir inheriting the farm or other business), the property is disposed of to nonfamily members or ceases to be used for the farming or other closely held business purposes based upon which it was valued in the decedent's estate, all or a portion of the Federal estate tax benefits obtained by virtue of the reduced valuation are recaptured by means of a special "additional estate tax" imposed on the heir who inherited the real property. A lien generally is imposed on the real estate for the amount of the additional estate tax.

To compute the amount of the reduction in estate tax value from current use valuation and the maximum amount of the potential "additional estate tax," and to determine the extent of the special estate tax lien required where an estate elects current use valuation, both the current use value and the fair market value of the qualified property must be established as of the date of death (or alternate valuation date, if elected).

Under present law, judicial review of tax issues generally is available only where there is a dispute over the correctness of a tax assessment (except in a few limited instances in which the Code contains provisions for declaratory judgments). Since the issue of the fair market value of specially valued property may not affect any presently assessable amount of tax where it is the only unresolved issue in an estate, there is no opportunity for judicial review of the issue under present law unless the entire use valuation election is disallowed.

<sup>1</sup>The maximum reduction is \$500,000 in the case of decedents dying before January 1, 1981, \$600,000 in the case of decedents dying in 1981, \$700,000 in 1982, and \$750,000 in the case of decedents dying in 1983 and subsequent years.

<sup>2</sup>The recapture period with respect to decedents dying before January 1, 1982, is 15 years.

***Installment payment of estate tax (sec. 6166)***

With respect to the estates of certain decedents dying before January 1, 1982, two overlapping provisions permit the estate taxes attributable to interests in closely held businesses to be paid in installments. If the value of an interest in a closely held business exceeds 65 percent of the value of the adjusted gross estate, the estate taxes attributable to the interest may be paid in installments for up to 14 years (annual interest may be paid in installments for up to 14 years (annual interest payments for four years, followed by up to ten annual installments of principal and interest) (sec. 6166). A special four-percent interest rate applies to tax on the first \$1 million of interests in closely held businesses (sec. 6601(j)). If the value of the interest in a closely held business exceeds either 35 percent of the gross estate or 50 percent of the taxable estate, the estate taxes attributable to the interest may be paid in up to ten annual installments (sec. 6166A).

With respect to the estates of decedents dying after December 31, 1981, section 422 of the Economic Recovery Tax Act of 1981 repealed section 6166A and expands the provisions of present law section 6166 to all estates in which the value of interests in closely held businesses exceeds 35 percent of the value of the adjusted gross estate. If the value of the interests in closely held businesses (reduced by allowable expenses, losses, and indebtedness) exceeds 35 percent of the value of the adjusted gross estate, the estate taxes may be deferred for up to 14 years (annual interest payments for four years, followed by up to ten annual installments of principal and interest). The special four-percent interest rate of present law continues to apply to estate taxes on the first \$1 million of interests in closely held businesses (sec. 6601(j)).

Under these installment payment provisions, the remaining unpaid tax is accelerated if there is a disposition or withdrawal of a specified fraction of the value of a decedent's interest in the business.<sup>3</sup> In addition, the remaining unpaid tax may be accelerated (1) if any installment of principal or interest is not paid on or before the date which is six months after the date fixed for the payment of such installment<sup>4</sup> or (2) the estate has undistributed net income in any taxable year ending on or after the due date of the first installment of principal.

Under present law, judicial review of tax issues generally is available only where there is a dispute over the correctness of a tax assessment (except in a few limited instances in which the Code contains provisions for declaratory judgments). Because the decision of the Treasury Department to deny an election to pay all or a portion of the estate tax attributable to interests in closely held businesses or a decision to accelerate the remaining tax involves a dispute as to the timing of estate tax payments rather than the amount of tax, no deficiency is involved and, therefore, the decision is not subject to judicial review.

<sup>3</sup> Under section 6166, the fraction is one-third with respect to the estates of decedents dying before January 1, 1982, and one-half with respect to the estates of decedents dying after December 31, 1981. In addition, for estates of decedents dying before January 1, 1982, who elected deferral under section 6166A (repealed by sec. 422 of the Economic Recovery Tax Act of 1981), the fraction is one-half.

<sup>4</sup> For the estates of decedents dying before January 1, 1982, payments may be accelerated if any installment of principal is not paid on or before the date fixed for the payment of such installment.

*Issues*

The issues are whether a judicial forum should be provided to review (1) Treasury Department determinations of the fair market value of property qualifying for section 2032A current use valuation (without the disallowance of the entire 2032A election), and (2) Treasury Department decisions regarding a section 6166 election to pay all or a portion of the estate tax attributable to interests in closely held businesses in installments.

*Explanation of the Bill**Current use valuation (sec. 2032A)*

The bill would permit an executor to request the Treasury Department to examine the fair market value of the qualified property and thereby determine that value for all purposes. The bill further provides that the Treasury would be able to initiate such audits without the executor's request and thereby determine the fair market value of the qualified property for all purposes.

If the Treasury Department determines that the fair market value of the specially valued property is different from that value as reported by the executor (either pursuant to an audit requested by the executor or an audit initiated by the Treasury), a notice of the Treasury's determination is to be sent to the executor by registered or certified mail. If the executor and the Treasury agree on the fair market value after the notice is sent, that value is binding on all parties in future actions. If the executor does not agree with the Treasury Department's determination, the executor has ninety days from the date on which notice of the Treasury's determination is sent in which to petition the Tax Court to review the fair market value of the property. A decision of the Tax Court is binding on all parties in future actions in which the fair market value of the specially valued property on the date of the decedent's death is at issue. The Tax Court declaration of the fair market value would have the force and effect of a decision of the Tax Court and would be reviewable as such.

Failure by the executor to petition the Tax Court within the ninety day period following the date on which the notice of the Treasury Department's determination is sent results in the value as determined by the Treasury being binding on all parties, except where a qualified heir establishes another value to the satisfaction of the Treasury Department. Any disagreement between the qualified heir and the Treasury Department arising from the heir's attempt to establish a different value is not subject to judicial review, except as provided below, and such a disagreement does not affect the binding nature of a previous determination for which judicial review was available.

Because the fair market value of the specially valued property determines the maximum amount of the recapture tax for which a qualified heir is personally liable, the heir is granted a right to intervene in any action brought by an executor. The heir is also given the right to initiate an action in the Tax Court himself within the ninety day period available to the executor. If the heir initiates such an action, the executor is joined as a party in interest.

If the Treasury Department does not determine that the fair market value of the property is different from that value as reported by the

executor on the decedent's estate tax return within the period of limitations for assessment of estate tax, the value as reported by the executor is not binding on the executor, the qualified heirs, or the Treasury Department in any future actions involving any matters arising under the current use valuation provision, the special lien under section 6324B, or with respect to the qualified heir's income tax basis in the specially valued property.

***Installment payment of estate tax (sec. 6166)***

The bill would provide a procedure for obtaining a declaratory judgment with respect to (1) an estate's eligibility for deferred payment of estate taxes attributable to an interest in a closely held business under section 6166, (2) the computation of the adjusted gross estate, based on the facts and circumstances in existence on the date (including extensions) for filing the estate tax return or, if earlier, the date such return was filed, and (3) whether there is an acceleration of the deferred payments. However, because this declaratory judgment procedure would only apply where there is an actual controversy, no declaratory judgment would be available prior to the decedent's death (with respect to eligibility for deferral or the amount of the adjusted gross estate) or prior to a transaction involving dispositions or withdrawals of an interest in a closely held business (with respect to whether there is an acceleration). Jurisdiction to issue a declaratory judgment would be limited to the Tax Court and the determination would have the force and effect of a Tax Court decision and be reviewable as such. This remedy would be available only if the petitioner (i.e., the executor of the decedent's estate) has exhausted all available administrative remedies within the Internal Revenue Service.

In addition, no petition to the Tax Court could be filed after 90 days from the date on which the Secretary or his delegate sends notice to the executor of his determination as to (1) the estate's eligibility for deferred payment, (2) the amount of the adjusted gross estate (determined on the facts and circumstances in existence on the date (including extensions) for filing the estate tax return, or, if earlier, the actual filing date), or (3) the application of the acceleration rules.

***Effective Date***

The bill would apply with respect to the estates of decedents dying after December 31, 1981.

***Revenue Effect***

It is estimated that this bill would have a negligible effect on budget receipts.

***Prior Congressional Action***

***Current use valuation***

A similar provision was included in section 421 of H.R. 4242 (the Economic Recovery Tax Act of 1981), as passed by the House. That provision was not agreed to in the conference on H.R. 4242.

***Installment payment of estate tax***

A similar provision was included in section 422 of H.R. 4242 (the Economic Recovery Tax Act of 1981) as passed by the House. That provision was not agreed to in the conference on H.R. 4242.

**2. S. 1734—Senator Baker (for Senator Symms)**

**Acceleration of Installment Payments of Estate Tax**

***Present Law***

With respect to the estates of certain decedents dying before January 1, 1982, two overlapping provisions permit the estate taxes attributable to interests in closely held businesses to be laid in installments. If the value of an interest in a closely held business exceeds 65 percent of the value of the adjusted gross estate, the estate taxes attributable to the interest may be paid in installments extending for up to 14 years (annual interest payments for four years, followed by up to ten annual installments of principal and interest) (sec. 6166). A special four-percent interest rate applies to tax on the first \$1 million of interests in closely held businesses (sec. 6601(j)). If the value of the interest in a closely held business exceeds either 35 percent of the gross estate or 50 percent of the taxable estate, the estate taxes attributable to the interest may be paid in up to ten annual installments (sec. 6166A).

With respect to the estates of decedents dying after December 31, 1981, section 422 of the Economic Recovery Tax Act of 1981 (ERTA) repeals section 6166A and expands the provisions of present law section 6166 to all estates in which the value of interests in closely held businesses exceeds 35 percent of the value of the adjusted gross estate. If the value of the interests in the closely held businesses exceeds 35 percent of the value of the adjusted gross estate, the estate taxes may be deferred for up to 14 years (annual interest payments for four years, followed by up to ten annual installments of principal and interest). The special four-percent interest rate of present law continues to apply to estate taxes on the first \$1 million of interests in closely held businesses (sec. 6601(j)).

Under section 6166, the remaining unpaid tax balance is accelerated if there is a disposition of a specified fraction of the value of a decedent's interest in the business.<sup>1</sup>

For purposes of the acceleration rules, the transfer of the decedent's interest in a closely held business from his estate to his heirs is not considered a disposition. This exception applies whether or not the interest passes to family members.

With respect to transfers made after December 31, 1981, ERTA provided that the transfer of an interest in a closely held business from an heir (or subsequent transferee) at his death to a family member (within the meaning of sec. 267(c)(4)) of the heir (or subsequent transferee) will not be considered a disposition.

<sup>1</sup> Under section 6166, the fraction is one-third respect to the estates of decedents dying before January 1, 1982, and one-half with respect to the estates of decedents dying after December 31, 1981. In addition, for estates of decedents dying before January 1, 1982, which elected deferral under section 6166A (repealed by sec. 422 of the Economic Recovery Tax Act of 1981), the fraction is one-half.



***Issue***

The issue is whether the present exception from the acceleration rules should be broadened to allow for transfers from an heir (or subsequent transferee) caused by the death of the heir (or subsequent transferee) where the property is transferred to a person who is not a family member of the heir or subsequent transferee.

***Explanation of the Bill***

The bill would further expand the exception from the acceleration rules for subsequent transfers caused by the death of an heir or subsequent transferee by eliminating the requirement that the interest in a closely held business pass to a family member of the heir or subsequent transferee. Thus, under the bill, any transfer of an interest in a closely held business caused by the death of the heir (or subsequent transferee) would not result in acceleration of the unpaid tax.

***Effective Date***

The bill would apply with respect to transfers made after December 31, 1981.

***Revenue Effect***

It is estimated that this bill would reduce budget receipts by \$5 million annually.

***Prior Congressional Action***

A similar provision was included in H.R. 4242, The Economic Recovery Tax Act of 1981, as passed by the Senate (floor amendment by Senator Symms, adopted by voice vote). That provision was not agreed to in the conference on H.R. 4242.

### **3. Other Tax Matters Relating to Installment Payment of Estate Tax (Code Sec. 6166) and Redemptions of Stock in Closely Held Corporations (Code Sec. 303)**

#### **a. Overview of present law**

With respect to the estates of certain decedents dying before January 1, 1982, two overlapping provisions permit the estate taxes attributable to interests in closely held businesses to be paid in installments. If the value of interests in closely held businesses exceeds 65 percent of the value of the adjusted gross estate, the estate taxes attributable to the interest may be deferred for up to 14 years (annual interest payments for four years, followed by up to ten annual installments of principal and interest) (sec. 6166). A special four-percent interest rate applies to tax on the first \$1 million of interests in closely held businesses (sec. 6601(j)). If the value of the interests in closely held businesses exceeds either 35 percent of the gross estate or 50 percent of the taxable estate, the estate taxes attributable to the interest may be paid in up to ten annual installments (sec. 6166A).

With respect to the estates of decedents dying after December 31, 1981, section 422 of the Economic Recovery Tax Act of 1981 repeals section 6166A and expands the provisions of present law section 6166 to all estates in which the value of an interest in a closely held business exceeds 35 percent of the value of the adjusted gross estate. If the value of the interests in the closely held businesses exceeds 35 percent of the value of the adjusted gross estate, the applicable estate taxes may be paid in installments extending for up to 14 years (annual interest payment for four years, followed by up to ten annual installments of principal and interest). The special four-percent interest rate of present law continues to apply to estate taxes on the first \$1 million of interests in closely held businesses (sec. 6601(j)).

#### **b. Issues relating to acceleration of installment payments of estate tax by reason of section 303 redemptions**

##### ***Present Law***

Under section 6166, payment of the remaining tax is accelerated upon the occurrence of certain events. One event which triggers acceleration is the withdrawal of funds from the business where such withdrawal equals or exceeds a specified fraction of the value of the decedent's interest in the trade or business.<sup>1</sup>

<sup>1</sup> Under section 6166, the fraction is one-third with respect to the estates of decedents dying before January 1, 1982, and one-half with respect to the estates of decedents dying after December 31, 1981. In addition, for estates of decedents dying before January 1, 1982, which elected deferral under section 6166A (repealed by sec. 422 of the Economic Recovery Tax Act of 1981), the fraction is one-half.



However, section 6166 also provides several exceptions to these acceleration rules. One such exception provides that redemptions of stock under section 303 (relating to certain redemptions for the payment of estate taxes and certain other expenses) will not be considered a withdrawal for purposes of the acceleration rules, provided that Federal estate taxes in an amount equal to the redemption proceeds is paid on or before the due date of the first installment which becomes due after the date of redemption.

With respect to the estates of decedents dying before January 1, 1982, if more than 50 percent of the gross estate (reduced by allowable expenses, losses, and indebtedness) consists of stock in a single corporation, redemption of all or a portion of that stock to pay estate taxes, funeral expenses, and administration expenses will be treated as a sale or exchange subject to capital gains treatment instead of dividend income (sec. 303). With respect to the estates of decedents dying after December 31, 1981, the special treatment for redemptions will be permitted if the decedent's interest in the corporation comprises at least 35 percent of the decedent's adjusted gross estate.

However, if a qualifying section 303 redemption is made to secure funds to pay State death taxes, funeral expenses, or administration expenses and Federal estate taxes are not paid in an amount equal to the proceeds from the redemption, such redemption will be considered a withdrawal which may trigger acceleration of the remaining unpaid tax.

#### **Issue**

The issue is whether the acceleration rules of section 6166 should be modified to provide that any redemption to which section 303 applies will not be considered a withdrawal of a decedent's interest in a closely held business if the proceeds of the redemption are used for any of the purposes enumerated in section 303.

#### **c. Issues relating to the definition of an interest in a closely held business**

##### ***Present Law***

Under section 6166, an interest in a closely held business is defined as (A) an interest as a proprietor in a trade or business carried on as a proprietorship; (B) an interest as a partner in a trade or business carried on as a partnership if (i) 20 percent or more of the partnership's total capital interest is included in determining the decedent's gross estate or (ii) such partnership had 15 or fewer partners; or (C) stock in a corporation carrying on a trade or business if (i) 20 percent or more of the value of such corporation's *voting* stock is included in determining the decedent's gross estate or (ii) such corporation has 15 or fewer shareholders.

The value of a decedent's interest in partnership profits which is included in his gross estate is not treated as an interest in a closely held business in determining either (1) whether the estate taxes attributable to interests in closely held businesses may be paid in installments or (2) the amount of estate tax which may be paid in installments. Similarly, the value of partnership or corporate indebtedness included in the decedent's gross estate is not considered an interest in a closely held business for purposes of section 6166.

**Attribution rules**

In determining the number of shareholders or partners, each individual generally is counted once. However, section 6166 also provides several rules for aggregating certain interests.

First, under a spousal attribution rule, stock or a partnership interest which is community property or which is jointly held by an individual and his spouse is attributed to the individual and is treated as held by one shareholder or partner. This rule does not attribute individually titled property held by a spouse to the other spouse.

Under the second attribution rule (the so-called "family attribution rule"), partnership interests or stock held by family members within the meaning of section 267(c)(4) (e.g., father, mother, spouse, brothers, sisters and descendants) will be treated as held by the decedent in counting the number of shareholders or partners.

In applying these two attribution rules, all stock or partnership interests held indirectly by a family member (e.g., through a corporation, partnership, estate, or trust) are also attributed first to the family member and then to the decedent.<sup>2</sup>

The spousal attribution rule and the family attribution rule overlap in the case of the jointly held property or community held property of the decedent and his spouse. However, the spousal attribution rule is broader than the family attribution rule in that the spousal attribution rule applies to all individuals (e.g., stock owned by individuals other than the decedent or his family) while the family attribution rule applies only to the decedent (e.g., stock owned by the decedent or his family).

The family attribution rule, which treats interests held by certain family members as owned by the decedent for purposes of determining the number of shareholders, does not apply to interests owned by spouses of a decedent's brothers or sisters. Thus, if a decedent's brothers or sisters predecease him, the interests owned by their surviving spouses will be treated as owned by a partner or shareholder other than the decedent. If the number of partners or shareholders then exceeds 15, the business will not be considered closely held unless 20 percent or more of the value of the partnership's capital interest or the corporation's voting stock is included in the decedent's gross estate.

**Subchapter S**

To qualify for special tax treatment under subchapter S of the Internal Revenue Code (which generally provides that the corporation's income or loss is taxed proportionately to the shareholders rather than the corporation), the corporation must have a limited number of

<sup>2</sup> In addition, an executor may elect to apply the family attribution rules to determine whether at least 20 percent of the capital interest or the value of voting stock in a business is included in the decedent's gross estate. However, in the case of stock, this election may be made only if there was no market on a stock exchange or in an over-the-counter market for such stock at the time of decedent's death. If an executor makes this election, then the special 4-percent interest rate will not apply and the period for the installment payment of estate taxes attributable to the closely held business interest may not exceed 10 years.

qualifying shareholders. For taxable years beginning after December 31, 1981, section 232 of the Economic Recovery Tax Act of 1981 (ERTA) increased this maximum number from 15 to 25.<sup>a</sup>

| <i>Period</i>            | <i>Sub-S</i> | <i>6166</i> | <i>6166A</i> |
|--------------------------|--------------|-------------|--------------|
| 1958-1976.....           | 10           | N.A.        | 10           |
| 1976-1978.....           | * 10         | 15          | 10           |
| 1978-1981.....           | 15           | 15          | 10           |
| 1981 and thereafter..... | 25           | 15          | N.A.         |

\*15 for certain existing corporations.

It should also be noted that subchapter S contains other restrictions not found in the estate tax deferral sections. For example, a corporation with 25 or fewer shareholders may not be eligible for subchapter S treatment if it is a member of an affiliated group or if some or all of those shareholders are certain types of trusts. Under the estate tax deferral provisions, no similar restrictions apply and a corporation will be considered closely held if it satisfies the numerical test. On the other hand, corporations eligible for the existing estate tax deferral sections include corporations which could not qualify as subchapter S corporations. For example, the estate tax deferral sections may apply to corporations that have more than 25 shareholders where the family attribution rules treat the corporation as having less than 15 shareholders or where the decedent's stock comprises more than 20 percent of his estate.

#### **Issues**

The issues are:

- (1) Whether the value of an interest in partnership profits which is included in a decedent's gross estate should be considered as an interest in a closely held business;
- (2) Whether the value of partnership or corporate indebtedness included in a decedent's gross estate should be considered an interest in a closely held business;
- (3) Whether the value of nonvoting stock includible in the decedent's estate should be considered in determining whether that corporation is closely held for purposes of the 20-percent test;
- (4) Whether the attribution rules should be modified (a) by combining the spousal and family attribution rules and (b) by expanding the family attribution rules to include interests held by spouses of a decedent's brothers and sisters (solely for purposes of section 6166); and
- (5) Whether it is appropriate to expand the definition of a closely held business to include corporations with 25 or fewer shareholders because such corporations may be eligible to make a subchapter S election.

<sup>a</sup> Historically, both the estate tax deferral provisions and the subchapter S provisions have provided benefits for closely held businesses. The following chart indicates the historical relationship between the section. (Sec. 6166A was originally sec. 6166, but was renumbered in 1976 with the enactment of new sec. 6166 and was repealed by ERTA with respect to the estates of decedents dying after December 31, 1981.)

**d. Issues relating to treatment of interest as an administration expense**

***Present Law***

If an estate elects to defer taxes under section 6166, interest is payable on the unpaid tax balance from the due date of the original return until the date of payment.<sup>4</sup>

Under present law, the interest attributable to the estate tax paid in installments may be deducted, for estate tax purposes, as an administration expense or as an income tax deduction (sec. 642(g)).<sup>5</sup>

If the interest is claimed as an administration expense, several problems arise. First, because the amount of interest is based on the unpaid estate tax, and the estate tax liability in turn is reduced by the allowable interest deduction, a complicated, interrelated computation is required. Further, because no deduction is permitted until the interest is actually paid or accrued,<sup>6</sup> a revised computation (and supplemental estate tax return) must be made after each payment.

***Issue***

The issue is whether an estate tax deduction for interest paid on installment payments of estate taxes should be allowed and, if so, whether the computation needed to establish the amount of the deduction can be simplified.

<sup>4</sup> Under section 6166, interest is payable at 4 percent with respect to the first \$345,800 of tax attributable to interests in closely held businesses, reduced by the unified credit (sec. 6601(j)). Interest on the remaining tax balance is computed at the statutory rate under section 6621 (12 percent currently to be increased to 20 percent in February 1982).

<sup>5</sup> See Rev. Rul. 78-125, 1978-1 C.B. 292; *Estate of Bahr v. Commissioner*, 68 T.C. 74 (1977), acq. 1978-1 C.B. 1.

<sup>6</sup> See Rev. Rul. 80-250, IRB 1980-37, 15.

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