[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS
(S. 1825, S. 1984, AND S. 2220)

RELATING TO

ESTATE AND GIFT TAXES

LISTED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE

ON MARCH 24, 1980

PREPARED FOR THE USE OF THE

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INTRODUCTION

This pamphlet provides a description of three tax bills (S. 1825, S. 1984, and S. 2220) scheduled for a public hearing on March 24, 1980, by the Finance Subcommittee on Taxation and Debt Management Generally. These bills relate to estate and gift taxes.

The first part of the pamphlet is a summary of the bills. This is followed by a more detailed description of the bills. This includes a discussion of present law, issues involved, an explanation of the provisions of the bills, effective dates, and estimated revenue effects.

I. SUMMARY

1. S. 1825—Senators Nelson, Pell, Roth, Cranston, Packwood, Melcher, Thurmond, and Jepsen

Estate Tax Adjustment Act of 1979

The bill would increase the size of present law unified credit for estate and gift tax purposes from $47,000 to $70,700. This would increase the amount of transfers that would not be subject to estate or gift tax from $175,625 to approximately $250,000. In addition, the bill would increase the unified credit during the phase-in period from $38,000 to $48,200 for 1979 and from $42,500 to $58,900 for 1980.

2. S. 1984—Senator Wallop

Estate and Gift Tax Amendments of 1979

The bill would make a number of changes to the present estate and gift tax laws. In general, the bill would provide an unlimited marital deduction for estate and gift tax purposes, increase the annual gift tax exclusion from $3,000 to $6,000, and liberalize the special estate tax valuation provisions in the case of certain property devoted to farming or other closely held business use.

3. S. 2220—Senators Nelson, Baucus, Heinz, and Stewart

Family Business Protection Act of 1980

The bill would reduce the value of real or tangible personal property devised to a child or spouse and used as a farm or in a trade or business by five percent of its value for each year that the spouse or child of the decedent materially participated (whether before or after the decedent's death) in the operation of the farm or the trade or business. If the spouse or child materially participated in the operation of the farm or the trade or business in the year during which the decedent died, that spouse or child will be deemed to have materially participated in the operation of the farm or the trade or business for the next five years. If the spouse or child disposes of the farm or the trade or business or ceases to use the property as a farm or in a trade or business during the five years after the decedent's death, the amount of the estate tax savings from the provision would be recaptured.

II. DESCRIPTION OF BILLS

1. S. 1825—Senators Nelson, Pell, Roth, Cranston, and Packwood

Estate Tax Adjustments Act of 1979

Present law

Prior to the Tax Reform Act of 1976, there was a $30,000 lifetime exemption for gift tax purposes and a $60,000 exemption for estate tax purposes. The Tax Reform Act of 1976 combined the separate estate and gift tax rates into a unified transfer tax rate. In addition, the 1976 Act converted the prior estate and gift tax exemptions into a unified credit. With the unified credit, the gross gift or estate tax is computed without any exemption and then the unified credit is subtracted to determine the amount of gift or estate tax. The amount of the unified credit when fully phased in is $47,000. With a unified credit of $47,000, there would be no estate or gift tax on transfers of up to $175,625.

The Tax Reform Act of 1976 provided that the $47,000 credit was to be phased-in over a five-year period. For gifts made and decedents dying in 1977, the unified credit was $30,000; $34,000 for 1978; $38,000 for 1979; $42,500 for 1980; and the full $47,000 for 1981 and thereafter.

Issue

The issue is whether the amount of the unified estate and gift tax credit should be increased.

Explanation of the bill

The bill would increase the amount of the unified estate and gift tax credit from $47,000 to $70,700. With a unified credit of $70,700, there would be no estate or gift tax on transfers aggregating approximately $250,000.[1] In addition, the bill increases the amount of the unified credit during the phase-in period. Under the bill, the unified credit for 1979 is $48,200 and $58,900 for 1980. In addition, the bill makes corresponding changes in the size of estates for which an estate tax return is required.

Effective date

The provisions of the bill would be effective for gifts made and decedents dying after December 31, 1978.

Revenue effect

It is estimated that this bill would reduce budget receipts by $0.4 billion in fiscal 1980, by $0.7 billion in fiscal 1981, by $1.1 billion in fiscal 1982.

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[1] Under the existing rate schedule, a unified credit of $70,800 would be necessary so that no estate or gift tax would be paid on transfers of up to $250,000.

2. S. 1984—Senator Wallop

Estate and Gift Tax Amendments of 1979

Present law

Marital deduction

For estate tax purposes, a deduction from the gross estate is allowed for qualified interests in property passing to a surviving spouse (Code sec. 2056). Under present law, the marital deduction is generally limited to 50 percent of the adjusted gross estate or $250,000, whichever is greater (sec. 2056(c)(1)(A)).

A marital deduction is also allowed for gift tax purposes with respect to lifetime gifts of qualified interests in property made to a spouse (sec. 2523). Under present law, the marital deduction equals (1) 100 percent of the first $100,000 of gifts; (2) zero with respect to the second $100,000 of gifts; and (3) 50 percent of the gifts above $200,000 (sec. 2523(a)(2)). If less than $200,000 of lifetime gifts are made, the marital deduction allowed for estate tax purposes will be adjusted.[1]

Gift tax

Under present law, an annual exclusion of $3,000 per donee is allowed with respect to gifts of present interests in property (sec. 2503(b)). For example, an individual may give five different individuals $3,000 each in cash and owe no gift tax. The annual exclusion has equalled $3,000 since January 1, 1943.

A gift made by a husband or wife may, with the consent of both, be treated for gift tax purposes as made one-half by each (sec. 2513). The full annual exclusion is allowed with respect to each spouse's one-half share of gifts of present interests in property.

In general, gifts made within three years before death are included in the donor's gross estate (sec. 2035(a)). If, however, the donor is not required to file a gift tax return with respect to gifts made to a particular donee during a calendar year, then the gifts made to that donee during that calendar year will not be included in the donor's gross estate under the three-year rule (sec. 2035(b)(2)).[2] Therefore, if an individual makes only gifts of present interests each year totalling, per donee, not more than $3,000, the gifts will not be included in the donor's gross estate under the three-year rule.

Valuation of property

For estate tax purposes, real property must ordinarily be valued at its highest and best use. If certain requirements are met, however, present law allows family farms and real property used in a closely

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[1] In general, the marital deduction for estate tax purposes will be reduced by the excess of (1) the deduction allowed with respect to gifts made after December 31, 1976, over (2) 50 percent of the gifts made after December 31, 1976.

[2] This exception does not apply to any transfer with respect to a life insurance policy (sec. 20?5(b)).

held business to be included in a decedent's gross estate at current use value rather than highest and best use value, provided that the gross estate may not be reduced more than $500,000 (sec. 2032A).

To qualify for current use valuation: (1) the decedent must have been a citizen or resident of the United States at his death; (2) the value of the farm or closely held business assets in the decedent's estate, including both real and personal property (but reduced by debts attributable to the real and personal property), must be at least 50 percent of the decedent's gross estate (reduced by debts and expenses); (3) at least 25 percent of the adjusted value of the gross estate must be qualified farm or closely held business real property; [3] (4) the real property qualifying for current use valuation must pass to a qualified heir; [4] (5) such real property must have been owned by the decedent or a member of his family and used or held for use as a farm or closely held business for 5 of the last 8 years prior to the decedent's death; and (6) there must have been material participation in the operation of the farm or closely held business by the decedent or a member of his family in 5 years out of the 8 years immediately preceding the decedent's death (sec. 2032A (a) and (b)).[5]

The current use value of all qualified real property may be determined under the multiple factor method (sec. 2032A(e)(8)). The multiple factor method takes into account factors normally used in the valuation of real estate, for example, comparable sales, and any other factors that fairly value the property.

If there is comparable land from which the average annual gross cash rental may be determined, then farm property may also be valued under the formula method (sec. 2032A(e)(7)(A)). Under the formula method, the value of qualified farm property is determined by (1) subtracting from the average annual gross cash rental for comparable land used for farming the average annual State and local real estate taxes for the comparable land, and (2) dividing that amount by the average annual effective interest rate for all new Federal Land Bank loans.[6]

On July 19, 1978, the Department of the Treasury issued proposed regulations defining gross cash rental under section 2032A.[7] Under the proposed regulations, if no comparable farm property had been leased on a cash basis, then the formula method could be applied by converting crop share rentals into cash rentals. If the crops were sold

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[3] For purposes of the 50 percent and 25 percent tests, the value of property is determined without regard to its current use value.

[4] The term "qualified heir" means a member of the decedent's family, including his spouse, lineal descendants, parents, and aunts or uncles of the decedent and their descendants.

[5] In the case of qualifying real property where the material participation requirement is satisfied, the real property which qualifies for current use valuation includes the farmhouse, or other residential buildings, and related improvements located on qualifying real property if such buildings are occupied on a regular basis by the owner or lessee of the real property (or by employees of the owner or lessee) for the purpose of operating or maintaining the real property or the business conducted on the property. Qualified real property also includes roads, buildings, and other structures and improvements functionally related to the qualified use.

[6] Each average annual computation must be made on the basis of the five most recent calendar years ending before the decedent's death.

[7] 43 Fed. Reg. 31,039 (1978).

for cash in a qualified transaction, the selling price would be considered the gross cash rental. If no qualified sale occurred, then the gross cash rental would equal the cash value of the crops on the date received on an established public agricultural commodities market.

On September 10, 1979, the Department of the Treasury withdrew the proposed definition of gross cash rental and published another proposed regulation defining gross cash rental.[8] The new proposed regulation provides that crop share rentals may not be used under the formula method. Consequently, under the proposed regulation, if no comparable land is rented solely for cash, the formula method may not be used and the qualified farm property may be valued only by the multiple factor method.

If, within 15 years after the death of the decedent (but before the death of the qualified heir), the property is disposed of to nonfamily members or ceases to be used for farming or other closely held business purposes, all or a portion of the Federal estate tax benefits obtained by virtue of the reduced valuation will be recaptured. A "cessation of qualified use" occurs if (1) the qualified property ceases to be used for the qualified use under which the property qualified for current use valuation or (2) during any period of 8 years ending after the date of the decedent's death and before the date of the death of the qualified heir, there have been periods aggregating 3 years or more during which there was no material participation by the qualified heir or a member of his family in the operation of the farm or other business (sec. 2032A (c)(7)).

The recapture provisions apply not only where the qualified real property is sold (or exchanged in a taxable transaction) to nonfamily members, but also where the property is disposed of to nonfamily members in a tax-free exchange, for example, a like-kind exchange under section 1031. If, however, an involuntary conversion of qualified real proprety occurs and the cost of qualified replacement property equals or exceeds the amount realized on the conversion, then, in general, the adjusted tax difference will not be recaptured as a result of the involuntary conversion (sec. 2032A(h)). Under present law, the special rules for involuntary conversions apply only if the qualified heir makes an election in accordance with section 2032A(h)(5).

The maximum amount subject to recapture, the "adjusted tax difference," is the excess of (1) the estate tax liability which would have been incurred had the current use valuation provision not been utilized over (2) the estate tax liability based on the current use valuation provisions (sec. 2032A(c)(2)). In general, if a recapture event occurs within 10 years of the decedent's death, the amount of the additional or "recapture" tax imposed with respect to the interest shall be an amount equal to the lesser of (1) the adjusted tax difference attributable to this interest or (2) the excess of the amount realized with respect to the interest over the value of the interest determined with the current use valuation.[9] If the recapture event occurs more than 10, but

[8] 44 Fed. Reg. 52,696 (1979).

[9] In cases where there is a cessation of qualifying use or a sale or exchange at other than arm's length, the amount of the additional tax imposed will be the lesser of (1) the adjusted tax difference attributable to the interest or (2) the excess of the fair market value of the interest over the current use valuation.

less than 15, years after the decedent's death (but prior to the death of the qualified heir), the maximum amount subject to recapture is reduced on a monthly basis (sec. 2032A(c)(3)).

Issues

The issues presented by the bill include the following:

(1) whether the marital deduction for estate tax purposes should be unlimited in amount;

(2) whether the marital deduction for gift tax purposes should be unlimited in amount;

(3) whether the gift tax annual exclusion should be increased;

(4) whether the amount of the gift tax annual exclusion allowable with respect to a gift for which a gift tax return is required to be filed should be excluded from the application of the rule that requires gifts made within three years before death to be included in the donor's gross estate;

(5) whether all material participation requirements under section 2032A should be repealed;

(6) whether the 25-percent test under section 2032A(b)(1)(B) should be repealed;

(7) whether the 50-percent test under section 2032A(b)(1)(A) should be increased to 65 percent of the adjusted value of the gross estate;

(8) whether the $500,000 limitation on the reduction of the value of the decedent's gross estate under section 2032A(a)(2) should be repealed;

(9) whether the estate tax benefit recapture period under section 2032A should be reduced from 15 years to 10 years;

(10) whether certain like-kind exchanges should not trigger recapture of the estate tax benefits under section 2032A, or trigger the recapture of only a proportionate amount of the estate tax benefits;

(11) whether an election should be required to secure the benefits of the special rules for involuntary conversions in section 2032A(h); and

(12) whether qualified farm property may be valued under the formula method in section 2032A(e)(7)(A) by converting crop share rents to cash if no comparable land is leased solely for cash and comparable land is leased partially or completely on a crop share basis.

Explanation of the bill

Section 2—Marital deduction

Section 2 of the bill would repeal the present limitations on the amount of the marital deduction available for estate and gift tax purposes. Under the bill, the marital deduction would be unlimited. The gift tax marital deduction would equal the value of all qualified gifts made to a spouse. Similarly, the estate tax marital deduction would equal the value of all qualified interests in property passing to a surviving spouse.

Section 3—Valuation of property

Section 3 of the bill would make several amendments to Section 2032A. First, the bill would repeal all material participation requirements under section 2032A. The decedent or members of his family would no longer be required to participate in the operation of the farm or business before the decedent's death, nor would any member of the decedent's family be required to participate in the operation of the farm or business after the decedent's death.

Second, the 50-percent test under section 2032A(b)(1)(A) would be increased to 65 percent of the adjusted value of the gross estate. In addition, the 25-percent test under section 2032A(b)(1)(B) would be repealed.

Third, the $500,000 limit on the reduction of the decedent's gross estate would be repealed. Consequently, the current use value, computed under section 2032A, would be substituted on the estate tax return for the highest and best use value.

Fourth, the period during which the adjusted tax difference could be recaptured would be reduced from 15 years to 10 years. The current rules applicable after the tenth year would be repealed.

Fifth, the bill would expressly provide that an exchange pursuant to section 1031 of the qualified real property solely for real property to be used for the same qualified use as the original qualified real property would not trigger a recapture of the adjusted tax difference. If, however, the like-kind exchange under section 1031 were not entirely for qualified property, then a proportionate amount of the adjusted tax difference would be payable.

Sixth, a qualified heir would not be required to make an election to secure the benefits of the special rules for involuntary conversions.

Finally, the bill would amend section 2032A to provide that if there is no comparable land from which to determine the average annual gross cash rental, then the average net share rental could be substituted for the average gross cash rental in applying the formula method. The net share rental would be (1) the value of the produce grown on the leased land received by the lessor, reduced by (2) the cash operating expenses of growing the produce that are paid, under the terms of the lease, by the lessor.

Section 4—Gift tax

One provision in section 4 would double the present annual exclusion for gift tax purposes from $3,000 to $6,000.

In addition, section 4 of the bill would exclude from the operation of the three-year rule in section 2035(a) the amount each gift subject to the annual exclusion allowable with respect to gifts for which a gift tax return is required to be filed. If a husband and wife agree to split a gift under section 2513(a), this exception to the three-year rule would include the total annual exclusion allowable to both the husband and the wife.

Effective dates

Section 2

The provisions in section 2 of the bill affecting the estate tax marital deduction would apply to the estates of decedents dying on or after the date of enactment. The provisions in section 2 affecting the gift tax marital deduction would apply to gifts made on or after the date of enactment.

Section 3

The provisions in section 3 of the bill would apply to the estates of decedents dying on or after the date of enactment.

Section 4

The provision in section 4 of the bill increasing the annual exclusion would apply to gifts made after December 31, 1979. The provision affecting section 2035 would apply to the estates of decedents dying after December 31, 1976.

Revenue effect

It is estimated that this bill would reduce budget receipts by $0.1 billion in fiscal 1981 and by $0.8 billion in fiscal 1982.

3. S. 2220—Senators Nelson, Baucus, Heinz, and Stewart

The Family Business Protection Act of 1980

Present law

Under present law, the full fair market value of property owned by the decedent at his death generally is subject to the Federal estate tax. The fair market value is the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. In the case of closely held businesses whose stock is not actively traded, the fair market value of the business is determined on a facts and circumstances basis. In doing so, the Internal Revenue Service looks at a number of factors which include (1) the nature of the business and the history of the enterprise from its inception; (2) the economic outlook in general and the condition and outlook of the specific industry in particular; (3) the book value of the stock and the financial condition of the business; (4) the earning capacity of the company; (5) the dividend-paying capacity; (6) whether or not the enterprise has goodwill or other intangible value; (7) sales of the stock and the size of the block of stock to be valued; and (8) the market price of stock or corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter. Rev. Rul. 59–60, 1959–1 C.B. 237.

Present law contains a statutory exception to the general rule that all property owned by the decedent at his death is to be valued for estate tax purposes at its fair market value. Under Code section 2032A, the value of farm real property (and other closely held businesses) is allowed to be valued at the value of the property used for farming purposes (or other business use) instead of its value determined at its highest and best use.

In order to qualify for this special farm valuation, several requirements must be met: (1) the farm or family business must comprise at least 50 percent of the decedent's estate; (2) the real property used in the farm or family business must comprise at least 25 percent of the decedent's estate; (3) during at least 5 of the 8 years prior to the decedent's death, either the decedent or a member of his family must own the farm or family business and must materially participate in its operation; and (4) the property must be used for farming or used in a trade or business. The maximum amount of reduction in the value of the farm or family business cannot exceed $500,000. In addition, the estate tax savings from the special valuation are recaptured if either the farm or family business is sold or an heir of the decedent ceases to materially participate in the operation of the farm or family business during the 10 year period after the decedent's death and before the death of the qualified heir. In addition, this recapture is phased out between the 10th and 15th years after the decedent's death.

Issue

The issue is whether other estate tax relief should be granted to the spouses or children of decedents' who owned property used in farming or other trades of businesses at their deaths.

Explanation of the bill

The bill would provide special estate tax relief for real or tangible personal property owned by the decedent that was either devoted to use as a farm or for farming purposes or is used in any other trade or business so long as the property passes to the spouse of the decedent or any child of the decedent. Under the bill, the value of such property that is includable in the gross estate of the decedent would be reduced by 5 percent for each taxable year during which the spouse of the decedent or any of his children materially participated (whether or not before or after the decedent's death) in the operation of the farm or other trade or business. Moreover, if a child or spouse materially participated in the operation of the farm or other trade or business in the taxable year of the decedent's death, the spouse or child would be deemed to have materially participated in the operation of the farm or other trade or business during the 5 succeeding taxable years (i.e., an automatic 30-percent discount for one year of participation). However, the maximum amount of discount for any property by reason of this special provision would be 50 percent of the value of the property. In addition, the maximum amount that the gross estate of the decedent can be reduced by reason of this provision and section 2040(d) would be $500,000.

If the spouse or child disposes of the qualified property or ceases to use the qualified property as a farm or in a trade or business within the five-year period after the death of the decedent, the entire amount of the estate tax savings arising under the provision would be recaptured. If these events occur after the five-year period, there would be no recapture of the estate tax benefits.

Effective date

The provisions of the bill would be effective for estates of decedents dying after December 31, 1979.

Revenue effect

It is estimated that this bill would reduce budget receipts by $0.2 billion annually.

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